

OLD SECOND BANCORP INC
Form 10-K
March 07, 2019
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 0-10537

Delaware 36-3143493
(State of Incorporation) (IRS Employer Identification Number)

37 South River Street, Aurora, Illinois 60507

(Address of principal executive offices, including zip code)

(630) 892-0202

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(Registrant's telephone number, including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Class	Name of each exchange on which registered
Common Stock, \$1.00 par value	The Nasdaq Stock Market
Preferred Securities of Old Second Capital Trust I	The Nasdaq Stock Market

Securities registered pursuant to Section 12(g) of the Act:

Preferred Share Purchase Rights

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by Reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b–2 of the Exchange Act.

Large accelerated filer	Accelerated filer	
Non-accelerated filer	Smaller reporting company	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes
No

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, on June 29, 2018, the last business day of the registrant’s most recently completed second fiscal quarter, was approximately \$422.4 million. The number of shares outstanding of the registrant's common stock, par value \$1.00 per share, was 29,889,985 at March 4, 2019.

DOCUMENTS INCORPORATED BY REFERENCE:

Certain information required by Part III of this Annual Report on Form 10-K is incorporated by reference from the registrant's definitive proxy statement relating to the 2019 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Annual Report on Form 10-K relates.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report and other publicly available documents of the Company contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act, including with respect to management's expectations regarding future plans, strategies and financial performance, including regulatory developments, industry and economic trends, and other matters. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company's management and on information currently available to management, can be identified by the inclusion of such qualifications as "expects," "intends," "believes," "may," "will," "would," "could," "should," "plan," "estimate," "possible," "likely" or other indications that the particular statements are not historical facts and refer to future periods. Because forward-looking statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict and may be outside of the Company's control. Actual events and results may differ materially from those described in such forward-looking statements due to numerous factors, including:

- negative economic conditions that adversely affect the economy, real estate values, the job market and other factors nationally and in our market area, in each case that may affect our liquidity and the performance of our loan portfolio;
- our ability to achieve anticipated results from our acquisition of Greater Chicago Financial Corp. depends on the state of the economic and financial markets going forward. Specifically, we may incur more credit losses than expected, cost savings may be less than expected, anticipated strategic gains may be significantly harder or take longer to achieve than expected or may not be achieved in their entirety, and customer attrition may be greater than expected;
- the financial success and viability of the borrowers of our commercial loans;
- changes in U.S. monetary policy, the level and volatility of interest rates, the capital markets and other market conditions that may affect, among other things, our liquidity and the value of our assets and liabilities;
- competitive pressures from other financial service businesses and from nontraditional financial technology ("FinTech") companies;
- any negative perception of our reputation or financial strength;
- ability to raise additional capital on acceptable terms when needed;
- ability to use technology to provide products and services that will satisfy customer demands and create efficiencies in operations;
- adverse effects on our information technology systems resulting from failures, human error or cyberattacks;
- adverse effects of failures by our vendors to provide agreed upon services in the manner and at the cost agreed, particularly our information technology vendors;
- the impact of any claims or legal actions, including any effect on our reputation;
- losses incurred in connection with repurchases and indemnification payments related to mortgages;
 - the soundness of other financial institutions and other counter-party risk;
- changes in accounting standards, rules and interpretations and the impact on our financial statements;
- our ability to receive dividends from our subsidiaries;
- a decrease in our regulatory capital ratios;
- adverse federal or state tax assessments;
- litigation or government enforcement actions;
 - legislative or regulatory changes, particularly changes in regulation of financial services companies;

- increased costs of compliance, heightened regulatory capital requirements and other risks associated with changes in regulation and the current regulatory environment, including the Dodd-Frank Act; and
- each of the factors and risks under the heading “Risk Factors.”

Because the Company’s ability to predict results or the actual effect of future plans or strategies is inherently uncertain, there can be no assurances that future actual results will correspond to any forward-looking statements and you should not rely on any forward-looking statements. Additionally, all statements in this Form 10-K, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events, except as required by applicable law.

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PART I

Item 1. Business

General

Old Second Bancorp, Inc. is a corporation organized under the laws of the State of Delaware in 1981 that serves as the bank holding company for its wholly-owned subsidiary bank, Old Second National Bank. Old Second National Bank (the “Bank”) is a national banking association headquartered in Aurora, Illinois, that operates through 29 banking centers located in Cook, DeKalb, DuPage, Kane, Kendall, LaSalle and Will counties in Illinois.

In this report, unless the context suggests otherwise, references to the “Company” refer to Old Second Bancorp, Inc. and references to “we,” “us,” and “our” mean the combined business of the Company, the Bank and its wholly-owned subsidiaries.

We conduct a full service community banking and trust business through the Bank and its wholly-owned subsidiaries:

- Old Second Affordable Housing Fund, L.L.C., which was formed for the purpose of providing down payment assistance for home ownership to qualified individuals;
- Station I, LLC, which is wholly-owned by the Bank to hold property acquired by the Bank through foreclosure or in the ordinary course of collecting a debt previously contracted with borrowers; and
- River Street Advisors, LLC, a wholly-owned subsidiary of the Bank, which was formed in May 2010 to provide investment advisory/management services.

Intercompany transactions and balances are eliminated in consolidation.

We are a full-service banking business offering a broad range of deposit products, trust and wealth management services, and lending services, including demand, NOW, money market, savings, time deposit and individual retirement accounts; commercial, industrial, consumer and real estate lending, including installment loans, agricultural loans, lines of credit and overdraft checking; safe deposit operations, and an extensive variety of additional services tailored to the needs of individual customers, such as the acquisition of U.S. Treasury notes and bonds, money orders, cashiers’ checks and foreign currency, direct deposit, discount brokerage, debit cards, credit cards, and other special services. Our lending activities include making commercial and consumer loans, primarily on a secured basis. Commercial lending focuses on business, capital, construction, inventory and real estate lending. Installment

lending includes direct and indirect loans to consumers and commercial customers.

We also offer a full complement of electronic banking services such as online and mobile banking and corporate cash management products including remote deposit capture, mobile deposit capture, investment sweep accounts, zero balance accounts, automated tax payments, ATM access, telephone banking, lockbox accounts, automated clearing house transactions, account reconciliation, controlled disbursement, detail and general information reporting, foreign and domestic wire transfers, vault services for currency and coin, and checking accounts. Additionally, we provide a wide range of wealth management, investment, agency, and custodial services for individual, corporate, and not-for-profit clients. These services include the administration of estates and personal trusts, as well as the management of investment accounts for individuals, employee benefit plans, and charitable foundations. We also originate residential mortgages, offering a wide range of mortgage products including conventional, government, and jumbo loans. We also handle secondary marketing of those mortgages.

We evaluate our operations as one operating segment, which is community banking. Financial information concerning our operations can be found in the financial statements in this annual report.

Completed Merger with Greater Chicago Financial Corp.

On April 20, 2018, we completed our acquisition of Greater Chicago Financial Corp., and its wholly-owned bank subsidiary, ABC Bank. In connection with the merger, Greater Chicago Financial Corp. merged with and into the Company, with the Company as the surviving company in the merger. Immediately following the merger, ABC Bank, an Illinois state-chartered bank and wholly-owned subsidiary of Greater Chicago Financial Corp., merged with and into the Bank, with the Bank as the surviving bank. With the acquisition of ABC Bank, we acquired four branches in the Chicago, Illinois, metropolitan area. ABC Bank had total assets with a fair value of \$336.9 million as of April 20, 2018, including \$227.6 million of loans, net of purchase accounting adjustments.

Market Area

Our main office is located at 37 South River Street, Aurora, Illinois 60507. The city of Aurora is located in northeastern Illinois, approximately 40 miles west of Chicago. The Bank operates primarily in Cook, DeKalb, DuPage, Kane, Kendall, LaSalle, and Will counties in Illinois, and it has developed a strong presence in these counties. The Bank offers its services to retail, commercial,

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industrial, and public entity customers in the Aurora, North Aurora, Batavia, St. Charles, Burlington, Elburn, Elgin, Kaneville, Sugar Grove, Lisle, Joliet, Yorkville, Plano, Wasco, Ottawa, Oswego, Sycamore, Frankfort, Chicago, Bensenville, and Chicago Heights communities and surrounding areas through its 29 banking locations that are located primarily west and south of the Chicago metropolitan area.

Lending Activities

We provide a broad range of commercial and retail lending services to corporations, partnerships, individuals and government agencies. We actively market our services to qualified borrowers, and our lending officers actively solicit the business of new borrowers entering our market areas as well as long-standing members of the local business community. We have established lending policies that include a number of underwriting factors to be considered in making a loan, including location, amortization, loan to value ratio, cash flow, pricing, documentation and the credit history of the borrower. In 2018, we originated approximately \$658.7 million in loans. Our total loan portfolio grew \$279.4 million in 2018 due to our acquisition of ABC Bank, organic originations and select portfolio purchases of leases and home equity loans from third parties. In addition, we originated approximately \$173.1 million of residential mortgage loans in 2018, which includes originations of loans held for sale of \$133.9 million. Proceeds from the sales of residential mortgage loans to third parties were \$137.6 million in 2018.

Our loan portfolio is comprised primarily of loans in the areas of commercial real estate, residential real estate, general commercial, construction real estate, leases, and consumer lending. As of December 31, 2018, commercial real estate loans represented approximately 43.5% (46.4% at year-end 2017) of our loan portfolio, residential mortgages represented approximately 21.6% (19.4% at year-end 2017), general commercial loans represented approximately 16.7% (16.9% at year-end 2017), home equity lines of credit represented 7.4% (7.0% at year-end 2017), construction lending represented approximately 5.7% (5.3% at year-end 2017), leases represented approximately 4.2% (4.2% at year-end 2017), and consumer and other lending represented less than 1.0% (less than 1.0% at year-end 2017). It is our policy to comply at all times with the various consumer protection laws and regulations including, but not limited to, the Equal Credit Opportunity Act, the Fair Housing Act, the Community Reinvestment Act, the Truth in Lending Act, and the Home Mortgage Disclosure Act.

Commercial Loans. We continue to focus on identifying commercial and industrial prospects in our new business pipeline with favorable results in 2018. As noted above, we are an active commercial lender in the Chicago metropolitan area, with primary markets in the city of Chicago, as well as west and south of Chicago. Commercial lending reflects revolving lines of credit for working capital, lending for capital expenditures on manufacturing equipment and lending to small business manufacturers, service companies, medical and dental entities as well as specialty contractors. We also have commercial and industrial loans to customers in food product manufacturing, food process and packing, machinery tooling manufacturing as well as service and technology companies. Collateral for these loans generally includes accounts receivable, inventory, equipment and real estate. In addition, we often secure personal guarantees to help assure repayment. Loans may be made on an unsecured basis if warranted by the overall financial condition of the borrower. Commercial term loans range principally from one to seven years with the majority falling in the one to five year range. Interest rates on commercial loans are a mixture of fixed and variable rates, with these rates often tied to the prime rate, a spread over the FHLB Chicago index rate, or LIBOR.

Repayment of commercial loans is largely dependent upon the cash flows generated by the operations of the commercial borrower. Our underwriting procedures identify the sources of those cash flows and seek to match the repayment terms of the commercial loans to the sources. Secondary repayment sources are typically found in collateralization and guarantor support.

Lease Financing Receivables. We continued growth of our lease portfolio in 2018 primarily with organic lease originations. The collateral for lease financing receivables primarily includes manufacturing and transportation equipment, and lease terms typically range from one to seven years, with the majority falling in the one to five year range. Growth in this portfolio reflects management's efforts to diversify lending product offerings, and improve loan concentration metrics.

Commercial Real Estate Loans. While management has been actively working to reduce our concentration in real estate loans, a large portion of the loan portfolio continues to be comprised of commercial real estate loans. As of December 31, 2018, approximately \$358.1 million, or 43.6% (42.2%, at year-end 2017) of the total commercial real estate loan portfolio of \$820.9 million consisted of loans to borrowers secured by owner occupied property. A primary repayment risk for a commercial real estate loan is interruption or discontinuance of cash flows from operations, which are usually derived from rent in the case of non-owner occupied commercial properties. Repayment could also be influenced by economic events, which may or may not be under the control of the borrower, or changes in regulations that negatively impact the future cash flow and market values of the affected properties. Repayment risk can also arise from general downward shifts in the valuations of classes of properties over a given geographic area such as the significant price adjustments that were observed by the Bank in 2008 through 2011. Property valuations could continue to be affected by changes in demand and other economic factors, which could further influence cash flows associated with the borrower and/or the property. We seek to mitigate these risks by staying apprised of market conditions and by maintaining underwriting practices that provide for adequate cash flow margins and multiple repayment sources as well as remaining in regular contact with our borrowers. In most cases, we have collateralized these loans and/or have taken personal guarantees to help assure repayment. Commercial real estate loans are primarily made based on the identified cash flow of the borrower and/or the property at origination and secondarily on the underlying

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real estate acting as collateral. Additional credit support is provided by the borrower for most of these loans and the probability of repayment is based on the liquidation value of the real estate and enforceability of personal and corporate guarantees if any exist.

Construction Loans. Our construction and development portfolio increased from \$85.2 million at December 31, 2017, to \$108.4 million at December 31, 2018, due to the ABC Bank acquisition as well as organic loan originations in strengthening markets. We use underwriting and construction loan guidelines to determine whether to issue loans on build-to-suit or build out arrangements of existing borrower properties.

Construction loans are structured most often to be converted to permanent loans at the end of the construction phase or, infrequently, to be paid off upon receiving financing from another financial institution. Construction loans are generally limited to our local market area. Lending decisions have been based on the “as-is” and “prospective” appraised value of the property as determined by an independent appraiser, an analysis of the potential marketability and profitability of the project and identification of a cash flow source to service the permanent loan or verification of a refinancing source. Construction loans generally have terms of 12 to 18 months, with extensions as needed. The Bank disburses loan proceeds in increments as construction progresses and as inspections warrant.

Development lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of the borrower or guarantor to repay principal and interest. Therefore, development lending generally involves more risk than other lending because it is based on future estimates of value and economic circumstances. While appraisals are required prior to funding, loan advances are limited to the “prospective” value determined by the appraisal, therefore there is the possibility of an unforeseen event affecting the value and/or costs of the project. Development loans are primarily used for multi-family developments, where the leasing of units is tied to local demand and rental rates, and commercial developments, where the success of the project is tied to the demand for commercial space, cap rates and leasing rates. If the borrower defaults prior to completion of the project, we may be required to fund additional amounts so that another developer can complete the project. We are located in an area where a large amount of development activity has occurred as rural and semi-rural areas are being suburbanized. This type of growth presents some economic risks should local demand for commercial buildings and multi-family housing shift. We address these risks by closely monitoring local real estate activity, adhering to proper underwriting procedures, closely monitoring construction projects, and limiting the amount of construction development lending.

Residential Real Estate Loans. Residential first mortgage loans and second mortgages are included in this category. First mortgage loans may include fixed rate loans that are generally sold to investors. We are a direct seller to the Federal National Mortgage Association (“FNMA”), Federal Home Loan Mortgage Corporation (“FHLMC”) and to several large financial institutions. We retain servicing rights for mortgages sold to FNMA and FHLMC. The retention of such servicing rights is a source of noninterest income and also allows us an opportunity to have regular contact with mortgage customers and can help to solidify our community involvement. Other loans that are not sold include adjustable rate mortgages, lot loans, and construction loans that are held in our portfolio. Loans sold to other investors, such as Federal Housing Administration (“FHA”), and the Veterans Administration (“VA”), are sold with servicing released. We had a moderate level of residential mortgage purchase activity in 2018; however, with interest

rates rising in 2018 in our market area, our residential mortgage lending portfolio reflected a reduction in volume and mixture of both refinance and purchase financing opportunities.

Home Equity Lines of Credit. Our home equity lines of credit, or HELOCs, consist of originated as well as purchased HELOCs. We had growth in our home equity lending in 2018, due to two portfolio purchases in March 2018 and November 2018 from a third party of \$20.9 million and \$20.7 million, respectively. We purchased these HELOCs at a 4.25% premium, and the average annualized yield on the total purchased HELOC portfolio in 2018 was 5.09%, net of the premium accretion.

Consumer Loans. We also provide many types of consumer loans including primarily motor vehicle, home improvement and signature loans. Consumer loans typically have shorter terms and lower balances with higher yields as compared to other loans but generally carry higher risks of default. Consumer loan collections are dependent on the borrower's continuing financial stability and thus are more likely to be affected by adverse personal circumstances.

Competition

Our market area is highly competitive and our business activities require us to compete with many other financial institutions. A number of these financial institutions are affiliated with large bank holding companies headquartered outside of our principal market area as well as other institutions that are based in Aurora's surrounding communities and in Chicago, Illinois. All of these financial institutions operate banking offices in the greater Chicago area or actively compete for customers within our market area. We also face competition from finance companies, insurance companies, credit unions, mortgage companies, securities brokerage firms, money market funds, loan production offices and other providers of financial services, including nontraditional financial technology companies or FinTech companies. Many of our nonbank competitors which are not subject to the same extensive federal regulations that govern bank holding companies and banks, such as the Company and the Bank, may have certain competitive advantages.

We compete for loans principally through the quality of our client service and our responsiveness to client needs in addition to competing on interest rates and loan fees. Management believes that our long-standing presence in the community and personal one-on-one service philosophy enhances our ability to compete favorably in attracting and retaining individual and business customers. We

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actively solicit deposit-related clients and compete for deposits by offering personal attention, competitive interest rates, and professional services made available through experienced bankers and multiple delivery channels that fit the needs of our market. In wealth management and trust services, we compete with a variety of custodial banks as well as a diverse group of investment managers.

We believe the financial services industry will likely continue to become more competitive as further technological advances enable more financial institutions to provide expanded financial services without having a physical presence in our market.

Employees

At December 31, 2018, the Company employed 518 full-time equivalent employees.

Available Information

We maintain a corporate website at <http://www.oldsecond.com>. We make available free of charge on or through our website the Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after the Company electronically files such material with, or furnishes it to, the Securities and Exchange Commission (the "SEC"). Many of our policies, committee charters and other investor information including our Code of Business Conduct and Ethics are available on our website. No information contained on our website is intended to be included as part of, or incorporated by reference into, this Annual Report on Form 10-K. The Company's reports, proxy and informational statements and other information regarding the Company are also available free of charge on the SEC's website (<http://www.sec.gov>). We will also provide copies of our filings free of charge upon written request to: Investor Relations, Old Second Bancorp, Inc., 37 South River Street, Aurora, Illinois 60507.

SUPERVISION AND REGULATION

General

FDIC-insured institutions, their holding companies and their affiliates, are extensively regulated under federal and state law. As a result, our growth and earnings performance may be affected not only by management decisions and general economic conditions, but also by the requirements of federal and state statutes and by the regulations and policies of various bank regulatory agencies, including the Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC") and the Consumer Financial Protection Bureau (the "CFPB"). Furthermore, taxation laws administered by

the Internal Revenue Service and state taxing authorities, accounting rules developed by the Financial Accounting Standards Board, securities laws administered by the Securities and Exchange Commission (the “SEC”) and state securities authorities, and anti-money laundering laws enforced by the U.S. Department of the Treasury (“Treasury”) have an impact on our business. The effect of these statutes, regulations, regulatory policies and accounting rules are significant to our operations and results.

Federal and state banking laws impose a comprehensive system of supervision, regulation and enforcement on the operations of FDIC-insured institutions, their holding companies and affiliates that is intended primarily for the protection of the FDIC-insured deposits and depositors of banks, rather than stockholders. These laws, and the regulations of the bank regulatory agencies issued under them, affect, among other things, the scope of our business, the kinds and amounts of investments we may make, reserve requirements, required capital levels relative to assets, the nature and amount of collateral for loans, the establishment of branches, our ability to merge, consolidate and acquire, dealings with our insiders and affiliates and the Company’s payment of dividends. In the last several years, we have experienced heightened regulatory requirements and scrutiny following the global financial crisis approximately 8 years ago, and as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Although the reforms primarily targeted systemically important financial service providers, their influence filtered down in varying degrees to community banks over time, and the reforms have caused our compliance and risk management processes, and the costs thereof, to increase.

This supervisory and regulatory framework subjects banks and their bank holding companies to regular examination by their respective regulatory agencies, which results in examination reports and ratings that are not publicly available and that can impact the conduct and growth of their business. These examinations consider not only compliance with applicable laws and regulations, but also capital levels, asset quality and risk, management ability and performance, earnings, liquidity, and various other factors. The regulatory agencies generally have broad discretion to impose restrictions and limitations on the operations of a regulated entity where the agencies determine, among other things, that such operations are unsafe or unsound, fail to comply with applicable law or are otherwise inconsistent with laws and regulations or with the supervisory policies of these agencies.

The following is a summary of certain of the material elements of the supervisory and regulatory framework applicable to the Company and the Bank. It does not describe all of the statutes, regulations and regulatory policies that apply, nor does it restate all of the requirements of those that are described. The descriptions are qualified in their entirety by reference to the particular statutory and regulatory provision.

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Regulatory Emphasis on Capital

Regulatory capital represents the net assets of a banking organization available to absorb losses. Because of the risks attendant to their business, FDIC-insured institutions are generally required to hold more capital than other businesses, which directly affects our earnings capabilities. While capital has historically been one of the key measures of the financial health of both bank holding companies and banks, its role became fundamentally more important in the wake of the global financial crisis, as the banking regulators recognized that the amount and quality of capital held by banks prior to the crisis was insufficient to absorb losses during periods of severe stress. Certain provisions of the Dodd-Frank Act and Basel III, discussed below, establish strengthened capital standards for banks and bank holding companies that are meaningfully more stringent than those in place previously.

Minimum Required Capital Levels. Banks have been required to hold minimum levels of capital based on guidelines established by the bank regulatory agencies since 1983. The minimums have been expressed in terms of ratios of capital divided by total assets. As discussed below, bank capital measures have become more sophisticated over the years and have focused more on the quality of capital and the risk of assets. Bank holding companies have historically had to comply with less stringent capital standards than their bank subsidiaries and have been able to raise capital with hybrid instruments such as trust preferred securities. The Dodd-Frank Act mandated the Federal Reserve to establish minimum capital levels for holding companies on a consolidated basis as stringent as those required for FDIC-insured institutions. A result of this change is that the proceeds of hybrid instruments, such as trust preferred securities, are being excluded from capital over a phase-out period. However, if such securities were issued prior to May 19, 2010 by bank holding companies with less than \$15 billion of assets, they may be retained, subject to certain restrictions. Because the Company has assets of less than \$15 billion, the Company is able to maintain its trust preferred proceeds as capital but the Company has to comply with new capital mandates in other respects and will not be able to raise capital in the future through the issuance of trust preferred securities.

The Basel III Rule. In July of 2013, the U.S. federal banking agencies approved the implementation of the Basel III regulatory capital reforms in pertinent part, and, at the same time, promulgated rules effecting certain changes required by the Dodd-Frank Act (the “Basel III Rule”). In contrast to capital requirements historically, which were in the form of guidelines, Basel III was released in the form of enforceable regulations by each of the regulatory agencies. The Basel III Rule is applicable to all banking organizations that are subject to minimum capital requirements, including federal and state banks and savings and loan associations, as well as to bank and savings and loan holding companies, other than “small bank holding companies” generally holding companies with consolidated assets of less than \$3 billion. The Company is currently considered a “small bank holding company.” More stringent requirements are imposed on “advanced approaches” banking organizations—those organizations with \$250 billion or more in total consolidated assets, \$10 billion or more in total foreign exposures, or that have opted in to the Basel II capital regime.

The OCC’s final capital rules included new risk-based capital and leverage ratios and refined the definition of what constitutes “capital” for purposes of calculating those ratios. The minimum capital-level requirements applicable to us under the final rule are:

- a new Common Equity Tier 1 risk-based capital ratio of 4.5%;
- a Tier 1 risk-based capital ratio of 6% (increased from the former 4% requirement);
- a total risk-based capital ratio of 8% (unchanged from the former requirement); and
- a leverage ratio of 4% (also unchanged from the former requirement).

The final rules also established a “capital conservation buffer” above the new regulatory minimum capital requirements, which must consist entirely of Common Equity Tier 1 capital, which was phased in over several years. The phase-in of the capital conservation buffer began on January 1, 2016, at a level of 0.625% of risk-weighted assets for 2016, increased to 1.250% for 2017, and 1.875% for 2018. The fully phased-in capital conservation buffer of 2.500%, which became effective on January 1, 2019, resulted in the following effective minimum capital ratios beginning in 2019: (i) a Common Equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if their capital levels fall below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

The Basel III Rule also changed the definition of capital by establishing more stringent criteria that instruments must meet to be considered Additional Tier 1 Capital (primarily non-cumulative perpetual preferred stock that meets certain requirements) and Tier 2 Capital (primarily other types of preferred stock and subordinated debt, subject to limitations). A number of instruments that previously qualified as Tier 1 Capital no longer qualify, or their qualifications changed. For example, noncumulative perpetual preferred stock, which used to qualify as simple Tier 1 Capital, does not qualify as Common Equity Tier 1 Capital, but qualifies as Additional Tier 1 Capital. The Basel III Rule also constrained the inclusion of minority interests, mortgage-servicing assets, and deferred tax assets in capital and requires deductions from Common Equity Tier 1 Capital in the event that such assets exceed a certain percentage of a banking institution’s Common Equity Tier 1 Capital.

Well-Capitalized Requirements. The ratios described above are minimum standards in order for banking organizations to be considered “adequately capitalized.” Bank regulatory agencies uniformly encourage banks to hold more capital and be “well-

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capitalized” and, to that end, federal law and regulations provide various incentives for banking organizations to maintain regulatory capital at levels in excess of minimum regulatory requirements. For example, a banking organization that is well-capitalized may: (i) qualify for exemptions from prior notice or application requirements otherwise applicable to certain types of activities; (ii) qualify for expedited processing of other required notices or applications; and (iii) accept, roll-over or renew brokered deposits. Higher capital levels could also be required if warranted by the particular circumstances or risk profiles of individual banking organizations. For example, the Federal Reserve’s capital guidelines contemplate that additional capital may be required to take adequate account of, among other things, interest rate risk, or the risks posed by concentrations of credit, nontraditional activities or securities trading activities. Further, any banking organization experiencing or anticipating significant growth would be expected to maintain capital ratios, including tangible capital positions (i.e., Tier 1 Capital less all intangible assets), well above the minimum levels.

Under the capital regulations of the OCC, in order to be well capitalized, a banking organization must maintain:

- A Common Equity Tier 1 Capital ratio to risk-weighted assets of 6.5% or more;
- A ratio of Tier 1 Capital to total risk-weighted assets of 8%;
- A ratio of Total Capital to total risk-weighted assets of 10%; and
- A leverage ratio of Tier 1 Capital to total adjusted average quarterly assets of 5% or greater.

It is possible under the Basel III Rule to be well-capitalized while remaining out of compliance with the capital conservation buffer discussed above.

As of December 31, 2018 the Bank was well-capitalized, as defined by OCC regulations. As of December 31, 2018, the Company had regulatory capital in excess of the Federal Reserve’s requirements and met the Basel III Rule requirements to be well-capitalized.

Prompt Corrective Action. An FDIC-insured institution’s capital plays an important role in connection with regulatory enforcement as well. Federal law provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. The extent of the regulators’ powers depends on whether the institution in question is “adequately capitalized,” “undercapitalized,” “significantly undercapitalized” or “critically undercapitalized,” in each case as defined by regulation. Depending upon the capital category to which an institution is assigned, the regulators’ corrective powers include: (i) requiring the institution to submit a capital restoration plan; (ii) limiting the institution’s asset growth and restricting its activities; (iii) requiring the institution to issue additional capital stock (including additional voting stock) or to sell itself; (iv) restricting transactions between the institution and its affiliates; (v) restricting the interest rate that the institution may pay on deposits; (vi) ordering a new election of directors of the institution; (vii) requiring that senior executive officers or directors be dismissed; (viii) prohibiting the institution from accepting deposits from correspondent banks; (ix) requiring the institution to divest certain subsidiaries; (x) prohibiting the payment of principal or interest on subordinated debt; and (xi) ultimately, appointing a receiver for the institution.

Regulation and Supervision of the Company

General. The Company, as the sole stockholder of the Bank, is a bank holding company. As a bank holding company, the Company is registered with, and subject to regulation, supervision and enforcement by, the Federal Reserve under the Bank Holding Company Act, as amended (the “BHCA”). The Company is legally obligated to act as a source of financial and managerial strength to the Bank and to commit resources to support the Bank in circumstances where the Company might not otherwise do so. Under the BHCA, the Company is subject to periodic examination by the Federal Reserve and is required to file with the Federal Reserve periodic reports of the Company's

operations and such additional information regarding the Company and the Bank as the Federal Reserve may require.

Acquisitions, Activities and Change in Control. The primary purpose of a bank holding company is to control and manage banks. The BHCA generally requires the prior approval of the Federal Reserve for any merger involving a bank holding company or any acquisition by a bank holding company of another bank or bank holding company. Subject to certain conditions (including deposit concentration limits established by the BHCA), the Federal Reserve may allow a bank holding company to acquire banks located in any state of the United States. In approving interstate acquisitions, the Federal Reserve is required to give effect to applicable state law limitations on the aggregate amount of deposits that may be held by the acquiring bank holding company and its FDIC-insured institution affiliates in the state in which the target bank is located (provided that those limits do not discriminate against out-of-state institutions or their holding companies) and state laws that require that the target bank have been in existence for a minimum period of time (not to exceed five years) before being acquired by an out-of-state bank holding company. Furthermore, in accordance with the Dodd-Frank Act, bank holding companies must be well-capitalized and examiners must rate them well-managed in order to effect interstate mergers or acquisitions. For a discussion of the capital requirements, see “Regulatory Emphasis on Capital” above.

The BHCA generally prohibits the Company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank and from engaging in any business other than that of banking, managing and controlling banks or furnishing services to banks and their subsidiaries. This general prohibition is subject to a number of exceptions. The principal exception allows bank holding companies to engage in, and to own shares of companies engaged in, certain businesses found by the Federal Reserve prior to November 11, 1999, to be “so closely related to banking ... as to be a proper incident thereto.” This authority would permit the Company to engage in a variety of banking-related businesses, including the ownership and operation of a savings association, or any entity engaged in consumer finance, equipment leasing, the operation of a computer service bureau (including software development) and mortgage banking and brokerage services. The BHCA does not place territorial restrictions on the domestic activities of nonbank subsidiaries of bank holding companies.

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Additionally, bank holding companies that meet certain eligibility requirements prescribed by the BHCA and elect to operate as financial holding companies may engage in, or own shares in companies engaged in, a wider range of nonbanking activities, including securities and insurance underwriting and sales, merchant banking and any other activity that the Federal Reserve, in consultation with the Secretary of the Treasury, determines by regulation or order is financial in nature or incidental to any such financial activity or that the Federal Reserve determines by order to be complementary to any such financial activity and does not pose a substantial risk to the safety or soundness of FDIC-insured institutions or the financial system generally. The Company has not elected to operate as a financial holding company.

The BHCA prohibits a company from, directly or indirectly, acquiring 25% or more (5% if the acquirer is a bank holding company) of any class of our voting stock or obtaining the ability to control in any manner the election of a majority of our directors or otherwise directing the management or policies of the Bank without prior application to and the approval of the Federal Reserve. Moreover, under the Change in Bank Control Act, any person or group of persons acting in concert who intends to acquire 10% or more of any class of our voting stock or otherwise obtain control over us would be required to provide prior notice to and obtain the non-objection of the OCC.

Capital Requirements. Bank holding companies are required to maintain capital in accordance with Federal Reserve capital adequacy requirements. For a discussion of capital requirements, see “Regulatory Emphasis on Capital” above.

Dividend Payments. The Company’s ability to pay dividends to its stockholders may be affected by both general corporate law considerations and policies of the Federal Reserve applicable to bank holding companies. As a Delaware corporation, the Company is subject to the limitations of the Delaware General Corporation Law (the “DGCL”). The DGCL allows the Company to pay dividends only out of its surplus (as defined and computed in accordance with the provisions of the DGCL) or if the Company has no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year.

As a general matter, the Federal Reserve has indicated that the board of directors of a bank holding company should eliminate, defer or significantly reduce dividends to stockholders if: (i) the company's net income available to stockholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends; (ii) the prospective rate of earnings retention is inconsistent with the company's capital needs and overall current and prospective financial condition; or (iii) the company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios. The Federal Reserve also possesses enforcement powers over bank holding companies and their non-bank subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations. Among these powers is the ability to proscribe the payment of dividends by banks and bank holding companies. In addition, under the Basel III Rule, financial institutions that seek to pay dividends will have to maintain 2.5% in Common Equity Tier 1 Capital attributable to the capital conservation buffer. See “Regulatory Emphasis on Capital – Capital and Related Requirements” above.

Incentive Compensation. There have been a number of developments in recent years focused on incentive compensation plans sponsored by bank holding companies and banks, reflecting recognition by the bank regulatory agencies and Congress that flawed incentive compensation practices in the financial industry were one of many factors contributing to the global financial crisis. Layered on top of that are the abuses in the headlines dealing with product cross-selling incentive plans. The result is interagency guidance on sound incentive compensation practices and proposed rulemaking by the agencies required under Section 956 of the Dodd-Frank Act.

The interagency guidance recognized three core principles; effective incentive plans are required to: (i) provide employees incentives that appropriately balance risk and reward; (ii) be compatible with effective controls and risk-management; and (iii) be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors. Much of the guidance addresses large banking organizations and, because of the

size and complexity of their operations, the regulators expect those organizations to maintain systematic and formalized policies, procedures, and systems for ensuring that the incentive compensation arrangements for all executive and non-executive employees covered by this guidance are identified and reviewed, and appropriately balance risks and rewards. Smaller banking organizations like the Company that use incentive compensation arrangements are expected to be less extensive, formalized, and detailed than those of the larger banks.

Section 956 of the Dodd-Frank Act required the banking agencies, the National Credit Union Administration, the SEC and the Federal Housing Finance Agency to jointly prescribe regulations that prohibit types of incentive-based compensation that encourage inappropriate risk taking and to disclose certain information regarding such plans. On June 10, 2016, the agencies released an updated proposed rule for comment. Section 956 will only apply to banking organizations with assets of greater than \$1 billion. The Company has consolidated assets greater than \$1 billion and less than \$50 billion and the Company is considered a Level 3 banking organization under the proposed rules. The proposed rules contain mostly general principles and reporting requirements for Level 3 institutions so there are no specific prescriptions or limits, deferral requirements or claw-back mandates. Risk management and controls are required, as is board or committee level approval and oversight. No final rule has been issued yet.

Monetary Policy. The monetary policy of the Federal Reserve has a significant effect on the operating results of financial or bank holding companies and their subsidiaries. Among the tools available to the Federal Reserve to affect the money supply are open market transactions in U.S. government securities, changes in the discount rate on bank borrowings and changes in reserve requirements against bank deposits. These means are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits, and their use may affect interest rates charged on loans or paid on deposits.

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Federal Securities Regulation. The Company's common stock is registered with the SEC under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Consequently, the Company is subject to the information, proxy solicitation, insider trading and other restrictions and requirements of the SEC under the Exchange Act.

Corporate Governance. The Dodd-Frank Act addressed many investor protection, corporate governance and executive compensation matters that affect most U.S. publicly traded companies. The Dodd-Frank Act (i) grants stockholders of U.S. publicly traded companies an advisory vote on executive compensation and so-called "golden parachute" payments, (ii) enhances independence requirements for compensation committee members, (iii) requires the SEC to adopt rules directing national securities exchanges to establish listing standards requiring all listed companies to adopt incentive-based compensation clawback policies for executive officers, and (iv) provides the SEC with authority to adopt proxy access rules that would allow stockholders of publicly traded companies to nominate candidates for election as a director and have those nominees included in a company's proxy materials. The SEC has completed the bulk (although not all) of the rulemaking necessary to implement these provisions.

Regulation and Supervision of the Bank

General. The Bank is a national bank, chartered by the OCC under the National Bank Act. The deposit accounts of the Bank are insured by the FDIC's Deposit Insurance Fund (the "DIF") to the maximum extent provided under federal law and FDIC regulations, currently \$250,000 per insured depositor category, and the Bank is a member of the Federal Reserve System. As a national bank, the Bank is subject to the examination, supervision, reporting and enforcement requirements of the OCC, the chartering authority for national banks. The FDIC, as administrator of the DIF, also has regulatory authority over the Bank.

Deposit Insurance. As an FDIC-insured institution, the Bank is required to pay deposit insurance premium assessments to the FDIC. Effective July 1, 2016, the FDIC changed its pricing system for banks under \$10 billion, so that minimum and maximum initial base assessment rates are based on supervisory ratings. The initial base assessment rates currently range from three basis points to 30 basis points. At least semi-annually, the FDIC updates its loss and income projections for the DIF and, if needed, increases or decreases the assessment rates, following notice and comment on proposed rulemaking.

The assessment base against which an FDIC-insured institution's deposit insurance premiums paid to the DIF are calculated based on its average consolidated total assets less its average tangible equity. This method shifts the burden of deposit insurance premiums toward those large depository institutions that rely on funding sources other than U.S. deposits.

The reserve ratio is the DIF balance divided by estimated insured deposits. The Dodd-Frank Act altered the minimum reserve ratio of the DIF, increasing the minimum from 1.15% to 1.35% of the estimated amount of total insured deposits, and eliminating the requirement that the FDIC pay dividends to FDIC-insured institutions when the reserve ratio exceeds certain thresholds. The reserve ratio reached 1.36% on September 30, 2018. Because the reserve ratio has reached 1.35%, two deposit insurance assessment changes occurred under FDIC regulations: (1) surcharges on insured depository institutions with total consolidated assets of \$10 billion or more (large institutions) will cease; and (2) banks with assets of less than \$10 billion, such as us, will receive assessment credits for the portion of their assessments that contributed to the growth in the reserve ratio from between 1.15% and 1.35%, to be applied when the reserve ratio is at or above 1.38%, with credits starting with the March 31, 2019 assessment invoiced in June 2019.

FICO Assessments. In addition to paying basic deposit insurance assessments, the FDIC collects Financing Corporation ("FICO") assessments to pay interest on FICO bonds. FICO bonds were issued in the late 1980's to recapitalize the (former) Federal Savings & Loan Insurance Corporation. The last of the remaining FICO bonds will mature in September 2019. The FICO assessment rate is adjusted quarterly and for the fourth quarter of 2018 was

0.35 basis points (35 cents per \$100 dollars of assessable deposits). We were informed by the FDIC that our final FICO assessments will be collected on March 31, 2019.

Supervisory Assessments. National banks are required to pay supervisory assessments to the OCC to fund the operations of the OCC. The amount of the assessment is calculated using a formula that takes into account the bank's size and its supervisory condition. During the year ended December 31, 2018, the Bank paid supervisory assessments to the OCC totaling \$504,000.

Capital Requirements. Banks are generally required to maintain capital levels in excess of other businesses. For a discussion of capital requirements, see "Regulatory Emphasis on Capital" above.

Liquidity Requirements. Liquidity is a measure of the ability and ease with which bank assets may be converted to cash. Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations. To remain viable, FDIC-insured institutions must have enough liquid assets to meet their near-term obligations, such as withdrawals by depositors. Because the global financial crisis was in part a liquidity crisis, Basel III also includes a liquidity framework that requires FDIC-insured institutions to measure their liquidity against specific liquidity tests. One test, referred to as the Liquidity Coverage Ratio ("LCR"), is designed to ensure that the banking entity has an adequate stock of unencumbered high-quality liquid assets that can be converted easily and immediately in private markets into cash to meet liquidity needs for a 30-calendar day liquidity stress scenario. The other test, known as the Net Stable Funding Ratio ("NSFR") is designed to promote more medium and long-term funding of the assets and activities of FDIC-insured institutions over a one-year horizon. These tests provide an incentive for banks and holding companies to increase their holdings in Treasury securities and other sovereign debt as a component of assets, increase the use of long-term debt as a funding source and rely on stable funding like core deposits (in lieu of brokered deposits).

In addition to liquidity guidelines already in place, the federal bank regulatory agencies implemented the Basel III LCR in 2014 and have proposed the NSFR. While the LCR only applies to the largest banking organizations in the country, as will the NSFR, certain elements are expected to filter down to all FDIC-insured institutions. The Company has adopted a modified version of the LCR as a

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part of measuring the liquidity at the Bank. The Company has no plans to adopt the NSFR and has not received regulatory guidance indicating a requirement to do so.

Dividend Payments. The primary source of funds for the Company is dividends from the Bank. Under the National Bank Act, a national bank may pay dividends out of its undivided profits in such amounts and at such times as the bank's board of directors deems prudent. Without prior OCC approval, however, a national bank may not pay dividends in any calendar year that, in the aggregate, exceed the bank's year-to-date net income plus the bank's retained net income for the two preceding years. The payment of dividends by any FDIC-insured institution is affected by the requirement to maintain adequate capital pursuant to applicable capital adequacy guidelines and regulations, and an FDIC-insured institution generally is prohibited from paying any dividends if, following payment thereof, the institution would be undercapitalized. As described above, the Bank exceeded its capital requirements under applicable guidelines as of December 31, 2018. Notwithstanding the availability of funds for dividends, however, the OCC may prohibit the payment of dividends by the Bank if it determines such payment would constitute an unsafe or unsound practice. In addition, under the Basel III Rule, institutions that seek the freedom to pay dividends will have to maintain 2.5% in Common Equity Tier 1 Capital attributable to the capital conservation buffer. See "Regulatory Emphasis on Capital" above.

Insider Transactions. The Bank is subject to certain restrictions imposed by federal law on "covered transactions" between the Bank and its "affiliates." The Company is an affiliate of the Bank for purposes of these restrictions, and covered transactions subject to the restrictions include extensions of credit to the Company, investments in the stock or other securities of the Company and the acceptance of the stock or other securities of the Company as collateral for loans made by the Bank. The Dodd-Frank Act enhanced the requirements for certain transactions with affiliates, including an expansion of the definition of "covered transactions" and an increase in the amount of time for which collateral requirements regarding covered transactions must be maintained.

Certain limitations and reporting requirements are also placed on extensions of credit by the Bank to its directors and officers, to directors and officers of the Company and its subsidiaries, to principal stockholders of the Company and to "related interests" of such directors, officers and principal stockholders. In addition, federal law and regulations may affect the terms upon which any person who is a director or officer of the Company or the Bank, or a principal stockholder of the Company, may obtain credit from banks with which the Bank maintains a correspondent relationship.

Safety and Soundness Standards/Risk Management. The federal banking agencies have adopted guidelines that establish operational and managerial standards to promote the safety and soundness of FDIC-insured institutions. The guidelines set forth standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings.

In general, the safety and soundness guidelines prescribe the goals to be achieved in each area, and each institution is responsible for establishing its own procedures to achieve those goals. If an institution fails to comply with any of the standards set forth in the guidelines, the FDIC-insured institution's primary federal regulator may require the institution to submit a plan for achieving and maintaining compliance. If an FDIC-insured institution fails to submit an acceptable compliance plan, or fails in any material respect to implement a compliance plan that has been accepted by its primary federal regulator, the regulator is required to issue an order directing the institution to cure the deficiency. Until the deficiency cited in the regulator's order is cured, the regulator may restrict the FDIC-insured institution's rate of growth, require the FDIC-insured institution to increase its capital, restrict the rates the institution pays on deposits or require the institution to take any action the regulator deems appropriate under the circumstances. Noncompliance with the standards established by the safety and soundness guidelines may also constitute grounds for other enforcement action by the federal bank regulatory agencies, including cease and desist orders and civil money penalty assessments.

During the past decade, the bank regulatory agencies have increasingly emphasized the importance of sound risk management processes and strong internal controls when evaluating the activities of the FDIC-insured institutions they supervise. Properly managing risks has been identified as critical to the conduct of safe and sound banking activities and has become even more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking markets. The agencies have identified a spectrum of risks facing a banking institution including, but not limited to, credit, market, liquidity, operational, legal and reputational risk. In particular, recent regulatory pronouncements have focused on operational risk, which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses. New products and services, third-party risk and cybersecurity are critical sources of operational risk that FDIC-insured institutions are expected to address in the current environment. The Bank is expected to have active board and senior management oversight; adequate policies, procedures, and limits; adequate risk measurement, monitoring, and management information systems; and comprehensive internal controls.

Branching Authority. National banks headquartered in Illinois, such as the Bank, have the same branching rights in Illinois as banks chartered under Illinois law, subject to OCC approval. Illinois law grants Illinois-chartered banks the authority to establish branches anywhere in the State of Illinois, subject to receipt of all required regulatory approvals.

The Dodd-Frank Act permits well-capitalized and well-managed banks to establish new interstate branches or acquire individual branches of a bank in another state (rather than the acquisition of an out-of-state bank in its entirety) without impediments.

Financial Subsidiaries. Under federal law and OCC regulations, national banks are authorized to engage, through “financial subsidiaries,” in any activity that is permissible for a financial holding company and any activity that the Secretary of the Treasury, in consultation with the Federal Reserve, determines is financial in nature or incidental to any such financial activity, except (i) insurance underwriting, (ii) real estate development or real estate investment activities (unless otherwise permitted by law), (iii) insurance company

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portfolio investments and (iv) merchant banking. The authority of a national bank to invest in a financial subsidiary is subject to a number of conditions, including, among other things, requirements that the bank must be well-managed and well-capitalized (after deducting from capital the bank's outstanding investments in financial subsidiaries). The Bank has not applied for approval to establish any financial subsidiaries.

Federal Home Loan Bank System. The Bank is a member of the Federal Home Loan Bank of Chicago (the "FHLBC"), which serves as a central credit facility for its members. The FHLBC is funded primarily from proceeds from the sale of obligations of the FHLBC system. It makes loans to member banks in the form of FHLBC advances. All advances from the FHLBC are required to be fully collateralized as determined by the FHLBC.

Transaction Account Reserves. Federal Reserve regulations require FDIC-insured institutions to maintain reserves against their transaction accounts (primarily NOW and regular checking accounts). For 2018, the first \$16.0 million of otherwise reservable balances are exempt from reserves and have a zero percent reserve requirement; for transaction accounts aggregating more than \$16.0 million to \$122.3 million, the reserve requirement is 3% of total transaction accounts; and for net transaction accounts in excess of \$122.3 million, the reserve requirement is 3% up to \$122.3 million plus 10% of the aggregate amount of total transaction accounts in excess of \$122.3 million. These reserve requirements are subject to annual adjustment by the Federal Reserve.

Community Reinvestment Act Requirements. The Community Reinvestment Act requires the Bank to have a continuing and affirmative obligation in a safe and sound manner to help meet the credit needs of its entire community, including low- and moderate-income neighborhoods. Federal regulators regularly assess the Bank's record of meeting the credit needs of its communities. Applications for additional acquisitions would be affected by the evaluation of the Bank's effectiveness in meeting its Community Reinvestment Act requirements. The Bank received an overall "outstanding" rating on its most recent CRA performance evaluation.

Anti-Money Laundering. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "Patriot Act") is designed to deny terrorists and criminals the ability to obtain access to the U.S. financial system and has significant implications for FDIC-insured institutions, brokers, dealers and other businesses involved in the transfer of money. The Patriot Act mandates financial services companies to have policies and procedures with respect to measures designed to address any or all of the following matters: (i) customer identification programs; (ii) money laundering; (iii) terrorist financing; (iv) identifying and reporting suspicious activities and currency transactions; (v) currency crimes; and (vi) cooperation between FDIC-insured institutions and law enforcement authorities. Bank regulators routinely examine institutions for compliance with these obligations, and this area has become a particular focus of the regulators in recent years. In addition, the regulators are required to consider compliance in connection with the regulatory review of certain applications. In recent years, regulators have expressed concern over banking institutions' compliance with anti-money laundering requirements and, in some cases, have delayed approval of their expansionary proposals. The regulators and other governmental authorities have been active in imposing "cease and desist" orders and significant money penalty sanctions against institutions found to be in violation of the anti-money laundering regulations.

Concentrations in Commercial Real Estate. Concentration risk exists when FDIC-insured institutions deploy too many assets to any one industry or segment. A concentration in commercial real estate is one example of regulatory concern. The interagency Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices guidance ("CRE Guidance") provides supervisory criteria, including the following numerical indicators, to assist bank examiners in identifying banks with potentially significant commercial real estate loan concentrations that may warrant greater supervisory scrutiny: (i) non-owner occupied commercial real estate loans exceeding 300% of capital and increasing 50% or more in the preceding three years; or (ii) construction and land development loans exceeding

100% of capital. The CRE Guidance does not limit banks' levels of commercial real estate lending activities, but rather guides institutions in developing risk management practices and levels of capital that are commensurate with the level and nature of their commercial real estate concentrations. On December 18, 2015, the federal banking agencies issued a statement to reinforce prudent risk-management practices related to CRE lending, having observed substantial growth in many CRE asset and lending markets, increased competitive pressures, rising CRE concentrations in banks, and an easing of CRE underwriting standards. The federal bank agencies reminded FDIC-insured institutions to maintain underwriting discipline and exercise prudent risk-management practices to identify, measure, monitor, and manage the risks arising from CRE lending. In addition, FDIC-insured institutions must maintain capital commensurate with the level and nature of their CRE concentration risk.

Based on the Bank's loan portfolio as of December 31, 2018, concentrations in commercial real estate did not exceed the 300% guideline for non-owner occupied commercial real estate loans, or the 100% guideline for construction and development loans.

Financial Privacy and Cybersecurity. Under privacy protection provisions of the Gramm-Leach-Bliley Act of 1999 and related regulations, we are limited in our ability to disclose non-public information about consumers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. Federal banking agencies have adopted guidelines for establishing information security standards and cybersecurity programs for implementing safeguards under the supervision of the board of directors. These guidelines, along with related regulatory materials, increasingly focus on risk management and processes related to information technology and the use of third parties in the provision of financial services.

Consumer Protection Regulations. The activities of the Bank are subject to a variety of statutes and regulations designed to protect consumers. Interest and other charges collected or contracted for by the Bank are subject to state usury laws and federal laws concerning interest rates. The loan operations of the Bank are also subject to federal laws applicable to credit transactions, such as:

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- the Truth-In-Lending Act (“TILA”) and Regulation Z, governing disclosures of credit and servicing terms to consumer borrowers and including substantial new requirements for mortgage lending and servicing, as mandated by the Dodd-Frank Act;
- the Home Mortgage Disclosure Act of 1975 and Regulation C, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the communities they serve;
- the Equal Credit Opportunity Act and Regulation B, prohibiting discrimination on the basis of race, color, religion, or other prohibited factors in extending credit;
- the Fair Credit Reporting Act of 1978, as amended by the Fair and Accurate Credit Transactions Act and Regulation V, as well as the rules and regulations of the FDIC governing the use and provision of information to credit reporting agencies, certain identity theft protections and certain credit and other disclosures;
- the Fair Debt Collection Practices Act and Regulation F, governing the manner in which consumer debts may be collected by collection agencies; and
- the Real Estate Settlement Procedures Act and Regulation X, which governs aspects of the settlement process for residential mortgage loans.

The deposit operations of the Bank are also subject to federal laws, such as:

- the FDIA, which, among other things, limits the amount of deposit insurance available per insured depositor category to \$250,000 and imposes other limits on deposit-taking;
- the Right to Financial Privacy Act, which imposes a duty to maintain the confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- the Electronic Funds Transfer Act and Regulation E, which governs automatic deposits to and withdrawals from deposit accounts and customers’ rights and liabilities arising from the use of automated teller machines and other electronic banking services; and
- the Truth in Savings Act and Regulation DD, which requires depository institutions to provide disclosures so that consumers can make meaningful comparisons about depository institutions and accounts.

The Consumer Financial Protection Bureau (the “CFPB”) is an independent regulatory authority housed within the Federal Reserve. The CFPB has broad authority to regulate the offering and provision of consumer financial products. The CFPB has the authority to supervise and examine depository institutions with more than \$10 billion in assets for compliance with federal consumer laws. The authority to supervise and examine depository institutions with \$10 billion or less in assets, such as the Bank, for compliance with federal consumer laws remains largely with those institutions’ primary regulators. However, the CFPB may participate in examinations of these smaller institutions on a “sampling basis” and may refer potential enforcement actions against such institutions to their primary regulators. As such, the CFPB may participate in examinations of the Bank.

The CFPB has issued a number of significant rules that impact nearly every aspect of the lifecycle of a residential mortgage loan. These rules implement Dodd-Frank Act amendments to the Equal Credit Opportunity Act, TILA and the Real Estate Settlement Procedures Act (“RESPA”). Among other things, the rules adopted by the CFPB require banks to: (i) develop and implement procedures to ensure compliance with a “reasonable ability-to-repay” test; (ii) implement new or revised disclosures, policies and procedures for originating and servicing mortgages, including, but not limited to, pre-loan counseling, early intervention with delinquent borrowers and specific loss mitigation procedures for loans secured by a borrower’s principal residence, and mortgage origination disclosures, which integrate

existing requirements under TILA and RESPA; (iii) comply with additional restrictions on mortgage loan originator hiring and compensation; and (iv) comply with new disclosure requirements and standards for appraisals and certain financial products.

Bank regulators take into account compliance with consumer protection laws when considering approval of any proposed expansionary proposals.

GUIDE 3 STATISTICAL DATA REQUIREMENTS

The statistical data required by Guide 3 of the Guides for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934 is set forth in the following pages. This data should be read in conjunction with the consolidated financial statements, related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" as set forth in Part II Items 7 and 8. All dollars in the tables are expressed in thousands.

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I. Distribution of Assets, Liabilities and Stockholders' Equity; Interest Rate and Interest Differential.

The following table sets forth certain information relating to our average consolidated balance sheets and reflects the yield on average interest earning assets and cost of average interest bearing liabilities for the years indicated obtained by dividing the related interest by the average balance of assets or liabilities. Average balances are derived from daily balances.

Analysis of Average Balances,
Tax Equivalent Interest and Rates
Years Ended December 31, 2018, 2017 and 2016

	2018 Average Balance	Interest	Rate %	2017 Average Balance	Interest	Rate %	2016 Average Balance	Interest	Rate %
Assets									
Interest earning deposits with financial institutions	\$ 17,540	\$ 334	1.90	\$ 12,224	\$ 134	1.08	\$ 33,226	\$ 169	0.50
Securities:									
Taxable	268,791	9,577	3.56	347,712	10,202	2.93	635,914	15,865	2.49
Non-taxable (TE)	277,555	10,558	3.80	208,142	9,137	4.39	36,643	1,295	3.53
Total securities	546,346	20,135	3.69	555,854	19,339	3.48	672,557	17,160	2.55
Dividends from FHLBC and FRBC	9,305	469	5.04	8,127	370	4.55	7,944	333	4.19
Loans and loans held-for-sale									
1	1,778,996	88,922	5.00	1,537,742	70,950	4.55	1,218,931	56,263	4.54
Total interest earning assets	2,352,187	109,860	4.67	2,113,947	90,793	4.25	1,932,658	73,925	3.78
Cash and due from banks	34,021	-	-	33,738	-	-	31,689	-	-
Allowance for loan and lease losses	(18,930)	-	-	(16,390)	-	-	(15,955)	-	-
	180,528	-	-	187,503	-	-	194,356	-	-

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Other noninterest bearing assets									
Total assets	\$ 2,547,806			\$ 2,318,798			\$ 2,142,748		
Liabilities and Stockholders' Equity NOW									
accounts	\$ 436,702	\$ 978	0.22	\$ 425,435	\$ 424	0.10	\$ 389,266	\$ 358	0.09
Money market accounts	307,259	843	0.27	278,826	349	0.13	273,101	274	0.10
Savings accounts	291,611	335	0.11	261,974	177	0.07	256,905	157	0.06
Time deposits	443,520	5,829	1.31	389,771	4,227	1.08	404,285	3,640	0.90
Interest bearing deposits	1,479,092	7,985	0.54	1,356,006	5,177	0.38	1,323,557	4,429	0.33
Securities sold under repurchase agreements	44,122	462	1.05	31,478	17	0.05	34,016	4	0.01
Other short-term borrowings	71,041	1,429	2.01	67,959	741	1.08	26,518	102	0.38
Junior subordinated debentures	57,663	3,716	6.44	57,615	4,002	6.95	57,567	4,334	7.53
Senior notes	44,109	2,688	6.09	44,010	2,689	6.11	2,050	112	5.46
Subordinated debt	-	-	-	-	-	-	42,910	949	2.18
Notes payable and other borrowings	14,696	398	2.71	-	-	-	477	8	1.65
Total interest bearing liabilities	1,710,723	16,678	0.97	1,557,068	12,626	0.81	1,487,095	9,938	0.67
Noninterest bearing deposits	608,762	-	-	547,719	-	-	476,422	-	-
Other liabilities	16,742	-	-	22,131	-	-	12,929	-	-
Stockholders' equity	211,579	-	-	191,880	-	-	166,302	-	-
Total liabilities and stockholders' equity	\$ 2,547,806			\$ 2,318,798			\$ 2,142,748		
		\$ 93,182			\$ 78,167			\$ 63,987	

Net interest income (TE)				
Net interest margin (TE)		3.96		3.70
Interest bearing liabilities to earning assets	72.73	%	73.66	%
			76.95	%
				3.31

1 Interest income from loans is shown on a tax equivalent basis, which is a non-GAAP financial measure as discussed below, and includes fees of \$1.1 million, \$2.4 million and \$2.5 million for 2018, 2017 and 2016, respectively. Nonaccrual loans are included in the above stated average balances.

For purposes of discussion, net interest income and net interest income to interest earning assets have been adjusted to a non-GAAP tax equivalent (“TE”) basis using a marginal rate of 21% for 2018 and 35% for 2017 and 2016 to more appropriately compare returns on tax-exempt loans and securities to other earning assets. The table below provides a reconciliation of each non-GAAP TE measure to the GAAP equivalent:

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	Effect of Tax Equivalent Adjustment					
	2018	2017	2016			
Interest income (GAAP)	\$ 107,617	\$ 87,505	\$ 73,379			
Taxable equivalent adjustment - loans	26	90	93			
Taxable equivalent adjustment - securities	2,217	3,198	453			
Interest income (TE)	109,860	90,793	73,925			
Less: interest expense (GAAP)	16,678	12,626	9,938			
Net interest income (TE)	\$ 93,182	\$ 78,167	\$ 63,987			
Net interest income (GAAP)	\$ 90,939	\$ 74,879	\$ 63,441			
Average interest earning assets	\$ 2,352,187	\$ 2,113,947	\$ 1,932,658			
Net interest income to total interest earning assets (GAAP)	3.87	% 3.54	% 3.28			%
Net interest income to total interest earning assets (TE)	3.96	% 3.70	% 3.31			%

The following table allocates the changes in net interest income to changes in either average balances or average rates for interest earning assets and interest bearing liabilities. Interest income is measured on a tax-equivalent basis using a 21% marginal rate for 2018 and a 35% marginal rate for 2017 and 2016. Interest income not yet received on nonaccrual loans is reversed upon transfer to nonaccrual status; future receipt of interest income is a reduction to principal while in nonaccrual status.

Analysis of Year-to-Year Changes in Net Interest Income

	2018 Compared to 2017			2017 Compared to 2016		
	Change Due to			Change Due to		
	Average Balance	Average Rate	Total Change	Average Balance	Average Rate	Total Change
Interest and dividend income						
Interest earning deposits	\$ 73	\$ 127	\$ 200	\$ 42	\$ (77)	\$ (35)
Securities:						
Taxable	(11,252)	10,627	(625)	(9,260)	3,597	(5,663)
Tax-exempt	2,369	(948)	1,421	7,456	386	7,842
Dividends from FHLBC and FRBC	57	42	99	8	29	37
Loans and loans held-for-sale	11,045	6,927	17,972	14,557	130	14,687
Total interest and dividend income	2,292	16,775	19,067	12,803	4,065	16,868
Interest expense						
NOW accounts	12	542	554	35	31	66
Money market accounts	39	455	494	6	69	75
Savings accounts	22	136	158	3	17	20
Time deposits	632	970	1,602	(125)	712	587

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Securities sold under repurchase agreements	10	435	445	-	13	13
Other short-term borrowings	34	654	688	293	346	639
Junior subordinated debentures	3	(289)	(286)	4	(336)	(332)
Senior notes	6	(7)	(1)	2,562	15	2,577
Subordinated debt	-	-	-	(475)	(474)	(949)
Notes payable and other borrowings	398	-	398	(4)	(4)	(8)
Total interest expense	1,156	2,896	4,052	2,299	389	2,688
Net interest and dividend income	\$ 1,136	\$ 13,879	\$ 15,015	\$ 10,504	\$ 3,676	\$ 14,180

1 The changes in net interest income are created by changes in both interest rates and volumes. In the table above, volume variances are computed using the change in volume multiplied by previous year's rate. Rate variances are computed using the change in rate multiplied by the previous year's volume. The change in interest due to both rate and volume has been allocated between factors in proportion to the relationship of absolute dollar amounts of the change in each.

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II. Investment Portfolio

The following table presents the composition of the securities portfolio by major category as of December 31 of each year indicated:

Securities Portfolio Composition

	2018	Fair	2017	Fair	2016	Fair
	Amortized	Value	Amortized	Value	Amortized	Value
	Cost		Cost		Cost	
Securities available-for-sale						
U.S. Treasury	\$ 4,006	\$ 3,923	\$ 4,002	\$ 3,947	\$ -	\$ -
U.S. government agencies	11,112	10,951	13,062	13,061	-	-
U.S. government agency mortgage-backed States and political subdivisions	14,407	14,075	12,372	12,214	42,511	41,534
Corporate bonds	277,112	274,067	272,240	278,092	68,718	68,703
Collateralized mortgage obligations	-	-	823	833	10,957	10,630
Asset-backed securities	66,494	64,429	66,892	65,939	174,352	170,927
Collateralized loan obligations	108,574	109,514	113,983	112,932	146,391	138,407
Total securities available-for-sale	65,162	64,289	54,271	54,421	102,504	101,637
	\$ 546,867	\$ 541,248	\$ 537,645	\$ 541,439	\$ 545,433	\$ 531,838

Some of our holdings of U.S. government agency mortgage-backed securities (“MBS”) and collateralized mortgage obligations (“CMOs”) are issuances of government-sponsored enterprises, such as Fannie Mae and Freddie Mac, which are not backed by the full faith and credit of the U.S. government. Some holdings of MBS and CMOs are issued by Ginnie Mae, which does carry the full faith and credit of the U.S. government. We also hold some MBS and CMOs that were not issued by U.S. government agencies and are typically credit-enhanced via over-collateralization and/or subordination. Holdings of asset-backed securities (“ABS”) were largely comprised of securities backed by student loans issued under the U.S. Department of Education’s (“DOE”) FFEL program, which generally provides a minimum 97% U.S. DOE guarantee of principal. These ABS securities also have added credit enhancement through over-collateralization and/or subordination. The majority of holdings issued by states and political subdivisions are general obligation or revenue bonds that have S&P or Moody’s ratings of AA- or higher. Other state and political

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subdivision issuances are unrated and generally consist of smaller investment amounts that involve issuers in our markets. The credit quality of these issuers is monitored and none have been identified as posing a material risk of loss. We also hold collateralized loan obligation (“CLOs”) securities that are generally backed by a pool of debt issued by multiple middle-sized and large businesses. The Company’s CLO S&P or Moody’s ratings distribution consists of 58% rated A, 26% rated AA and 14% rated AAA. CLO credit enhancement is achieved through over-collateralization and/or subordination.

Securities Portfolio Maturity and Yields

The following table presents the expected maturities or call dates and weighted average yield (nontax equivalent) of securities by major category as of December 31, 2018. Securities not due at a single maturity date are shown only in the total column.

	Within One Year		After One But Within Five Years		After Five But Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Securities available-for-sale										
U.S. Treasury	\$ -	-	\$ 3,923	1.85 %	\$ -	-	\$ -	-	\$ 3,923	1.85 %
U.S. government agencies	-	-	-	-	-	-	10,951	2.93 %	10,951	2.93
States and political subdivisions	495	0.56 %	2,938	2.21	6,275	3.25 %	264,359	3.02	274,067	3.01
	495	0.56	6,861	2.00	6,275	3.25	275,310	3.02	288,941	2.99
Mortgage-backed securities and collateralized mortgage obligations	-	-	-	-	-	-	-	-	78,504	3.24
Asset-backed securities	-	-	-	-	-	-	-	-	109,514	3.65
Collateralized loan obligations									64,289	5.05
Total securities available-for-sale	\$ 495	0.56 %	\$ 6,861	2.00 %	\$ 6,275	3.25 %	\$ 275,310	3.02 %	\$ 541,248	3.41 %

As of December 31, 2018, net unrealized losses on available-for-sale securities totaled \$5.6 million, which offset by deferred income taxes resulted in an overall decrease to equity capital of \$4.0 million. As of December 31, 2017, net unrealized gains on available-for-sale securities totaled \$3.8 million, which offset by deferred income taxes resulted in an overall increase to equity capital of \$2.2 million.

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At December 31, 2018, there were three issuers of ABS and CMOs where the book value of our holdings were greater than 10% of our stockholders' equity, as follows:

Issuer	December 31, 2018	
	Amortized Cost	Fair Value
GCO Education Loan Funding Corp	\$ 27,739	\$ 27,763
Towd Point Mortgage Trust	34,308	33,318
Student Loan Marketing Association "(SLMA)"	25,808	26,119

III.Loan Portfolio

Types of Loans

The following table presents the composition of the loan portfolio at December 31 for the years indicated:

	2018	2017	2016	2015	2014
Commercial	\$ 314,849	\$ 273,234	\$ 229,030	\$ 116,343	\$ 119,717
Leases	79,224	68,325	55,451	25,712	8,038
Real estate - commercial	820,605	750,991	736,247	605,721	600,629
Real estate - construction	108,053	85,162	64,720	19,806	44,795
Real estate - residential	408,438	312,497	275,571	245,025	253,321
HELOC	140,442	112,833	101,626	105,532	116,549
Other ¹	14,451	14,580	16,164	15,576	16,283
Gross loans, excluding PCI loans	1,886,062	1,617,622	1,478,809	1,133,715	1,159,332
PCI loans, net of purchase accounting adjustments	10,965	—	—	—	—
Gross loans	1,897,027	1,617,622	1,478,809	1,133,715	1,159,332
Allowance for loan and lease losses	(19,006)	(17,461)	(16,158)	(16,223)	(21,637)
Loans, net	\$ 1,878,021	\$ 1,600,161	\$ 1,462,651	\$ 1,117,492	\$ 1,137,695

1 The “Other” class includes consumer loans and overdrafts.

Maturity and Rate Sensitivity of Loans to Changes in Interest Rates

The following table sets forth the remaining contractual maturities for loan categories at December 31, 2018:

	One Year or Less	Over 1 Year Through 5 Years		Over 5 Years		Total
		Fixed Rate	Floating Rate	Fixed Rate	Floating Rate	
Commercial	\$ 159,424	\$ 87,751	\$ 54,149	\$ 4,399	\$ 9,126	\$ 314,849
Leases	3,282	63,288	-	11,861	793	79,224
Real estate - commercial	143,637	393,703	84,726	57,467	145,254	824,787
Real estate - construction	68,685	7,460	21,731	5,480	5,442	108,798
Real estate - residential	34,879	167,667	16,355	17,506	178,069	414,476
HELOC	4,746	2,351	12,752	55,748	64,845	140,442
Other ¹	5,047	3,698	5,108	401	197	14,451
Total ²	\$ 419,700	\$ 725,918	\$ 194,821	\$ 152,862	\$ 403,726	\$ 1,897,027

1 The “Other” class includes consumer loans and overdrafts; column one includes demand notes.

2 The “Total” is inclusive of PCI loans, net of purchase accounting adjustments of \$11.0 million within the appropriate loan category.

While there are no significant concentrations of loans where the customers’ ability to honor loan terms is dependent upon a single economic sector, the real estate related categories represented 77.9% and 78.0% of the portfolio at December 31, 2018 and 2017, respectively. We had no concentration of loans exceeding 10% of total loans that were not otherwise disclosed as a category of loans at December 31, 2018.

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Risk Elements

The following table sets forth the amounts of nonperforming assets at December 31 for the years indicated:

	2018	2017	2016	2015	2014
Nonaccrual loans	\$ 13,741	\$ 14,388	\$ 15,283	\$ 14,389	\$ 26,926
Performing troubled debt restructured loans accruing interest	1,683	988	718	165	154
Loans past due 90 days or more and still accruing interest	917	248	-	65	-
Total nonperforming loans	16,341	15,624	16,001	14,619	27,080
Other real estate owned	7,175	8,371	11,916	19,141	31,982
Total nonperforming assets	\$ 23,516	\$ 23,995	\$ 27,917	\$ 33,760	\$ 59,062
PCI loans, net of purchase accounting adjustments	\$ 10,965	\$ -	\$ -	\$ -	\$ -
Other real estate owned ("OREO") as % of nonperforming assets, excluding PCI loans	30.5 %	34.9 %	42.7 %	56.7 %	54.1 %

We do not consider our purchased credit impaired ("PCI") loans, which showed evidence of deteriorated credit quality at acquisition, to be nonperforming assets as long as their cash flows and the timing of such cash flows continue to be estimable and probable of collection. Therefore, interest income is recognized through accretion of the difference between the carrying value of these loans and the present value of expected future cash flows. As a result, management has excluded PCI loans from the nonperforming assets in the table above. Accrual of interest is discontinued on a loan when principal or interest is 90 days or more past due, unless the loan is well secured and in the process of collection. When a loan is placed on nonaccrual status, interest previously accrued but not collected in the current period is reversed against current period interest income. Interest income of approximately \$335,000, \$47,000 and \$230,000 was recorded and collected during 2018, 2017 and 2016, respectively, on loans that subsequently went to nonaccrual status by year-end. Interest income, which would have been recognized during 2018, 2017 and 2016, had these loans been on an accrual basis throughout the year, was approximately \$952,000, \$781,000 and \$918,000, respectively. There were approximately \$6.6 million and \$5.7 million in restructured residential mortgage loans that were still accruing interest based upon their prior performance history at December 31, 2018 and 2017, respectively. Additionally, the nonaccrual loans above include \$2.1 million and \$2.5 million in restructured loans for the years ending December 31, 2018 and 2017, respectively.

Potential Problem Loans

We utilize an internal asset classification system as a means of reporting problem and potential problem assets. At the scheduled board of directors meetings of the Bank, loan listings are presented, which show significant loan relationships listed as “Special Mention,” “Substandard,” and “Doubtful.” Loans classified as Substandard include those that have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as Doubtful have all the weaknesses inherent as those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Assets that do not currently expose us to sufficient risk to warrant classification in one of the aforementioned categories, but possess weaknesses that deserve management’s close attention, are deemed to be Special Mention.

Management defines potential problem loans as performing loans rated Substandard that do not meet the definition of a nonperforming loan. These potential problem loans carry a higher probability of default and require additional attention by management. A more detailed description of these loans can be found in Note 5 to the Consolidated Financial Statements.

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IV. Summary of Loan Loss Experience

Analysis of Allowance for Loan and Lease Losses

The following table summarizes, for the years indicated, activity in the allowance for loan and lease losses (“ALLL”), including amounts charged-off, amounts of recoveries, additions to the allowance charged to operating expense, and the ratio of net charge-offs to average loans outstanding:

	2018	2017	2016	2015	2014
Average total loans (exclusive of loans held-for-sale)	\$ 1,776,230	\$ 1,534,673	\$ 1,214,804	\$ 1,144,618	\$ 1,124,335
Allowance at beginning of year	17,461	16,158	16,223	21,637	27,281
Charge-offs:					
Commercial	41	25	95	993	578
Leases	13	215	23	-	-
Real estate - commercial	1,548	309	1,633	1,653	1,972
Real estate - construction	(16)	23	23	2	174
Real estate - residential	(45)	1,347	450	665	1,453
HELOC	147	386	622	974	1,940
Other ¹	409	1	344	483	526
Total charge-offs	2,097	2,306	3,190	4,770	6,643
Recoveries:					
Commercial	157	30	32	451	58
Leases	-	-	5	-	-
Real estate - commercial	447	161	640	1,595	1,346
Real estate - construction	35	377	96	276	633
Real estate - residential	1,146	980	486	579	1,351
HELOC	364	243	845	496	491
Other ¹	265	18	271	359	420
Total recoveries	2,414	1,809	2,375	3,756	4,299
Net (recoveries) / charge-offs	(317)	497	815	1,014	2,344
Provision (release) for loan and lease losses	1,228	1,800	750	(4,400)	(3,300)
Allowance at end of year	\$ 19,006	\$ 17,461	\$ 16,158	\$ 16,223	\$ 21,637
Net (recoveries) / charge-offs to average loans	(0.02)	% 0.03	% 0.07	% 0.09	% 0.21
Allowance at year end to average loans	1.07	% 1.14	% 1.33	% 1.42	% 1.92

¹ The “Other” class includes consumer loans and overdrafts.

The provision for loan and lease losses is based upon management's estimate of losses inherent in the loan and lease portfolio and its evaluation of the adequacy of the ALLL. Factors which influence management's judgment in estimating loan and lease losses are the composition of the portfolio, past loss experience, loan delinquencies, nonperforming loans, national and local economic conditions, and other credit risk considerations that, in management's judgment, deserve evaluation in estimating loan and lease losses.

Allocation of the Allowance for Loan and Lease Losses

The following table shows our allocation of the ALLL by loan type at December 31 for the years indicated, and, for each category of loans, the percent of total loans represented by that category:

	2018		2017		2016		2015	
	Amount	Loan Type to Total Loans	Amount	Loan Type to Total Loans	Amount	Loan Type to Total Loans	Amount	Loan Type to Total Loans
Commercial	\$ 2,832	16.6	\$ 2,453	16.9	\$ 1,629	15.4	\$ 2,096	12.5
Leases	734	4.2	692	4.2	633	3.8	-	-
Real estate - commercial	10,470	43.5	9,522	46.4	9,547	49.8	9,013	53.4
Real estate - construction	969	5.8	923	5.3	389	4.4	265	1.7
Real estate - residential	1,931	21.8	1,846	19.4	2,178	18.7	724	21.7
HELOC	1,449	7.4	1,446	7.0	1,331	6.9	2,050	9.3
Other ¹	621	0.7	579	0.8	451	1.0	2,075	1.4
Total	\$ 19,006	100.0	\$ 17,461	100.0	\$ 16,158	100.0	\$ 16,223	100.0

¹ The "Other" class includes consumer loans, overdrafts and the unallocated allowance balance for each year presented.

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The ALLL is a valuation allowance, which increased by the provision for loan and lease losses of \$1.2 million, \$1.8 million and \$750,000 in 2018, 2017 and 2016, respectively, adjusted for charge-offs less recoveries. Allocations of the allowance may be made for specific loans, but the entire allowance is available for losses inherent in the loan portfolio. In addition, the OCC, as part of their examination process, periodically reviews the ALLL. Regulators can require management to record adjustments to the allowance level based upon their assessment of the information available to them at the time of examination. The OCC, in conjunction with the other federal banking agencies, has adopted an interagency policy statement on the ALLL. The policy statement provides guidance for financial institutions on both the responsibilities of management for the assessment and establishment of adequate allowances and guidance for banking agency examiners to use in determining the adequacy of general valuation guidelines. Generally, the policy statement recommends that (1) institutions have effective systems and controls to identify, monitor and address asset quality problems; (2) management has analyzed all significant factors that affect the collectability of the portfolio in a reasonable manner; and (3) management has established acceptable allowance evaluation processes that meet the objectives set forth in the policy statement and that the Company is in full compliance with the policy statement. Management believes it has established an adequate estimated allowance for probable loan and lease losses. Management reviews its process quarterly as evidenced by an extensive and detailed loan review process, makes changes as needed, and reports those results at meetings of the Company's Board of Directors and Audit Committee. Although management believes the ALLL is sufficient to cover probable losses inherent in the loan portfolio, there can be no assurance that the allowance will prove sufficient to cover actual loan and lease losses or that regulators, in reviewing the loan portfolio, would not request us to materially adjust our ALLL at the time of their examination.

V. Deposits

The following table sets forth the amount and maturities of deposits of \$100,000 or more at December 31 of the years indicated:

	2018	2017
3 months or less	\$ 58,036	\$ 25,233
Over 3 months through 6 months	46,453	16,875
Over 6 months through 12 months	48,932	37,086
Over 12 months	72,973	87,084
	\$ 226,394	\$ 166,278

YTD Average Balances and Interest Rates

2018

2017

2016

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	Average Balance	Rate %	Average Balance	Rate %	Average Balance	Rate %
Noninterest bearing demand	\$ 608,762	-	\$ 547,719	-	\$ 476,422	-
Interest bearing:						
NOW and money market	743,961	0.24	704,261	0.11	662,367	0.10
Savings	291,611	0.11	261,974	0.07	256,905	0.06
Time	443,520	1.31	389,771	1.08	404,285	0.90
Total deposits	\$ 2,087,854		\$ 1,903,725		\$ 1,799,979	

VI.Return on Equity and Assets

The following table presents selected financial ratios as of December 31 for the years indicated:

	2018		2017		2016	
Return on average total assets	1.33	%	0.65	%	0.73	%
Return on average equity	16.08		7.89		9.43	
Average equity to average assets	8.30		8.28		7.76	
Dividend payout ratio	3.51		7.84		5.66	

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VII.Short-Term Borrowings

Other short-term borrowings, which consisted of FHLBC advances and a short-term line of credit at U.S. Bank, totaled \$149.5 million as of December 31, 2018, and reflected a weighted average rate of 2.50%. Average other short-term borrowings totaled \$71.0 million, and reflected a weighted average rate of 2.01%, for the year ended December 31, 2018; this average borrowing balance was 33.6% of total equity as of the year ended December 31, 2018. The maximum amount of other short-term borrowings outstanding at any month end in 2018 was \$149.5 million as of December 31, 2018. FHLBC advances are short-term, usually overnight, and amounts borrowed are dependent upon the daily cash flow needs of the Company. The short-term line of credit totaled \$20.0 million, with \$4.0 million outstanding as of December 31, 2018. This line is held for the Company's operating needs at the holding company level, and was repaid in late January 2019.

There were no other categories of short-term borrowings that had an average balance greater than 30% of the Company's stockholders' equity as of December 31, 2018, 2017 and 2016.

Item 1A. Risk Factors

RISK FACTORS

There are risks, many beyond our control, which could cause our results to differ significantly from management's expectations. Some of these risk factors are described below. Any factor described in this Annual Report on Form 10-K could, by itself or together with one or more other factors, adversely affect our business, results of operations and/or financial condition. Additional risks and uncertainties not currently known to us or that we currently consider to not be material also may materially and adversely affect us. In assessing these risks, you should also refer to other information disclosed in our SEC filings, including the financial statements and notes thereto. The risks discussed below also include forward-looking statements, and actual results may differ substantially from those discussed or implied in these forward-looking statements.

Risks Relating to Our Business

A return of recessionary conditions could result in increases in our level of nonperforming loans and/or reduced demand for our products and services, which could lead to lower revenue, higher loan and lease losses and lower earnings.

A return of recessionary conditions and/or negative developments in the domestic and international credit markets may significantly affect the markets in which we do business, the value of our loans and investments and our ongoing operations, costs and profitability. Despite a general improvement in the overall economy and the real estate market, the economic environment remains challenging, particularly in our market area. Declines in real estate values and sales volumes and increased unemployment or underemployment levels may result in higher than expected loan delinquencies, increases in our levels of nonperforming and classified assets and a decline in demand for our products and services. These negative events may cause us to incur losses and may adversely affect its capital, liquidity and financial condition.

We may not be able to implement our growth strategy or manage costs effectively, resulting in lower earnings or profitability.

There can be no assurance that we will be able to continue to grow and to be profitable in future periods, or, if profitable, that our overall earnings will remain consistent or increase in the future. Our strategy is focused on organic growth, supplemented by opportunistic acquisitions, such as the acquisition of ABC Bank. Our growth requires that we increase our loans and deposits while managing risks by following prudent loan underwriting standards without increasing interest rate risk or compressing our net interest margin, maintaining more than adequate capital at all times, hiring and retaining qualified employees and successfully implementing strategic projects and initiatives. Even if we are able to increase our interest income, our earnings may nonetheless be reduced by increased expenses, such as additional employee compensation or other general and administrative expenses and increased interest expense on any liabilities incurred or deposits solicited to fund increases in assets. Additionally, if our competitors extend credit on terms we find to pose excessive risks, or at interest rates which we believe do not warrant the credit exposure, we may not be able to maintain our lending volume and could experience deteriorating financial performance. Our inability to manage our growth successfully or to continue to expand into new markets could have a material adverse effect on our business, financial condition or results of operations.

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Nonperforming assets take significant time to resolve, adversely affect our results of operations and financial condition and could result in further losses in the future.

Our nonperforming loans (which consist of nonaccrual loans, loans past due 90 days or more still accruing interest and restructured loans still accruing interest) and our nonperforming assets (which include nonperforming loans plus OREO) are reflected in the table below at December 31. We do not consider our PCI loans to be nonperforming assets as long as their cash flows and the timing of such cash flows continue to be estimable and probable of collection, because we recognize interest income on these loans through accretion of the difference between the carrying value of these loans and the present value of expected future cash flows. As a result, management has excluded PCI loans from nonperforming assets in the table below.

	2018	2017	% Change
Nonperforming loans	\$ 16,341	\$ 15,624	4.6
OREO	7,175	8,371	(14.3)
Total nonperforming assets	\$ 23,516	\$ 23,995	(2.0)

Our nonperforming assets adversely affect our net income in various ways. For example, we do not accrue interest income on nonaccrual loans and OREO may have expenses in excess of any lease revenues collected, thereby adversely affecting our net income, return on assets and return on equity. Our loan administration costs also increase because of our nonperforming assets. The resolution of nonperforming assets requires significant time commitments from management, which can be detrimental to the performance of their other responsibilities. There is no assurance that we will not experience increases in nonperforming assets in the future, or that our nonperforming assets will not result in losses in the future.

Our loan portfolio is concentrated heavily in commercial and residential real estate loans, including exposure to construction loans, which involve risks specific to real estate values and the real estate markets in general.

Our loan portfolio generally reflects the profile of the communities in which we operate. Because we operate in areas that saw rapid historical growth, real estate lending of all types is a significant portion of our loan portfolio. Total real estate lending, excluding PCI loans, was \$1.48 billion, or approximately 77.9%, of our loan portfolio at December 31, 2018, compared to \$1.26 billion, or approximately 78.0%, at December 31, 2017. Given that the primary (if not only) source of collateral on these loans is real estate, adverse developments affecting real estate values in our market area could increase the credit risk associated with our real estate loan portfolio.

In addition, with respect to commercial real estate loans, the banking regulators are examining commercial real estate lending activity with greater scrutiny, and may require banks with higher levels of commercial real estate loans to implement improved underwriting, internal controls, risk management policies and portfolio stress testing, as well as possibly higher levels of allowances for losses and capital levels as a result of commercial real estate lending growth and exposures. At December 31, 2018, our outstanding commercial real estate loans, including owner occupied real estate, were equal to 298.7% of our total risk-based capital. If our regulators require us to maintain higher levels of capital than we would otherwise be expected to maintain, this could limit our ability to leverage our capital and have a material adverse effect on our business, financial condition, results of operations and prospects.

Real estate market volatility and future changes in disposition strategies could result in net proceeds that differ significantly from our fair value appraisals of loan collateral and OREO and could negatively impact our operating performance.

Many of our nonperforming real estate loans are collateral-dependent, meaning the repayment of the loan is largely dependent upon the value of the property securing the loan and the borrower's ability to refinance, recapitalize or sell the property. For collateral-dependent loans, we estimate the value of the loan based on the appraised value of the underlying collateral less costs to sell. Our OREO portfolio essentially consists of properties acquired through foreclosure or deed in lieu of foreclosure in partial or total satisfaction of certain loans as a result of borrower defaults. Some property in OREO reflects property formerly utilized as a bank premise or land that was acquired with the expectation that a bank premise would be established at the location. In some cases, the market for such properties has been significantly depressed, and we have been unable to sell them at prices or within timeframes that we deem acceptable. OREO is recorded at the fair value of the property when acquired, less estimated selling costs. In determining the value of OREO properties and loan collateral, an orderly disposition of the property is generally assumed. Significant judgment is required in estimating the fair value of property, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility. In response to market conditions and other economic factors, we may utilize alternative sale strategies other than orderly disposition as part of our OREO disposition strategy, such as immediate liquidation sales. In this event, as a result of the significant judgments required in estimating fair value and the variables involved in different methods of disposition, the net proceeds realized from such sales transactions could differ significantly from appraisals, comparable sales and other estimates used to determine the fair value of our OREO properties.

If we fail to effectively manage credit risk, our business and financial condition will suffer.

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We must effectively manage credit risk. As a lender, we are exposed to the risk that our borrowers will be unable to repay their loans according to their original contractual terms, and that the collateral securing repayment of their loans, if any, may not be sufficient to ensure repayment. In addition, there are risks inherent in making any loan, including risks relating to proper loan underwriting, risks resulting from changes in economic and industry conditions and risks inherent in dealing with individual borrowers, including the risk that a borrower may not provide information to us about its business in a timely manner, and/or may present inaccurate or incomplete information to us, and risks relating to the value of collateral. In order to manage credit risk successfully, we must, among other things, maintain disciplined and prudent underwriting standards and ensure that our lenders follow those standards. The weakening of these standards for any reason, such as an attempt to attract higher yielding loans, a lack of discipline or diligence by our employees in underwriting and monitoring loans, the inability of our employees to adequately adapt policies and procedures to changes in economic or any other conditions affecting borrowers and the quality of our loan portfolio, may result in loan defaults, foreclosures and additional charge-offs and may necessitate that we significantly increase our ALLL, each of which could adversely affect our net income. As a result, our inability to successfully manage credit risk could have a material adverse effect on our business, financial condition or results of operations.

Our allowance for loan and lease losses, or ALLL, may be insufficient to absorb potential losses in our loan portfolio, which may adversely affect our business, financial condition and results of operations.

Our success depends significantly on the quality of our assets, particularly loans. Like other financial institutions, we are exposed to the risk that our borrowers may not repay their loans according to their terms, and the collateral securing the payment of these loans may be insufficient to fully compensate us for the outstanding balance of the loan plus the costs to dispose of the collateral. As a result, we may experience significant loan and lease losses that may have a material adverse effect on our operating results and financial condition.

We maintain an ALLL at a level we believe is adequate to absorb estimated losses inherent in our existing loan portfolio. The level of the allowance reflects management's continuing evaluation of industry concentrations; specific credit risks; credit loss experience; current loan portfolio quality; present economic, political, and regulatory conditions; and unidentified losses inherent in the current loan portfolio.

While we had loan loss reserve releases in 2014 and 2015, our provision for loan and lease losses was increased in 2016, 2017 and 2018, which is commensurate with the loan and lease portfolio growth experienced in those years. We may be required to make significant increases in the provision for loan and lease losses and to charge-off additional loans in the future.

Determination of the ALLL is inherently subjective since it requires significant estimates and management judgment of credit risks and future trends, all of which may undergo material changes. For example, the final allowance for 2018, 2017 and 2016 included an amount reserved for other not specifically identified risk factors. New information

regarding existing loans, identification of additional problem loans, and other factors, both within and outside of our control, may require an increase in the ALLL. In addition, bank regulatory agencies periodically review our allowance and may require an increase in the provision for loan and lease losses or the recognition of additional loan charge-offs, based on judgments different from those of management. If charge-offs in future periods exceed the ALLL, we will need additional provisions to increase the allowance. Any increases in the ALLL will result in a decrease in net income and capital and may have a material adverse effect on our financial condition and results of operations.

The application of the purchase method of accounting in our acquisition of ABC Bank and any future acquisitions will impact our ALLL. Under the purchase method of accounting, all acquired loans are recorded in our consolidated financial statements at their estimated fair value at the time of acquisition and any related ALLL is eliminated because credit quality, among other factors, is considered in the determination of fair value. To the extent that our estimates of fair value are too high, we will incur losses associated with the acquired loans.

Finally, the measure of our ALLL is dependent on the adoption and interpretation of accounting standards. The Financial Accounting Standards Board, or FASB, recently issued a new credit impairment model, the Current Expected Credit Loss, or CECL model, which will become applicable to us in 2020. Under the CECL model, we will be required to present certain financial assets carried at amortized cost, such as loans held for investment and held-to-maturity debt securities, at the net amount expected to be collected. The measurement of expected credit losses is to be based on information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. This measurement will take place at the time the financial asset is first added to the balance sheet and periodically thereafter. This differs significantly from the “incurred loss” model currently required under GAAP, which delays recognition until it is probable a loss has been incurred. Accordingly, we expect that the adoption of the CECL model will materially affect how we determine our ALLL and could require us to significantly increase our ALLL. Moreover, the CECL model may create more volatility in the level of our ALLL. If we are required to materially increase our level of ALLL for any reason, such increase could adversely affect our business, financial condition and results of operations.

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Our business is geographically concentrated in several counties in Illinois, which makes our business highly susceptible to downturns in these local economies.

Unlike larger financial institutions that are more geographically diversified, our banking franchise is concentrated in Aurora, Illinois, and its surrounding communities, as well as Cook County. The city of Aurora is located in northeastern Illinois, approximately 40 miles west of Chicago. We operate primarily in Cook, DeKalb, DuPage, Kane, Kendall, LaSalle and Will counties in Illinois, and, as a result, our financial condition, results of operations and cash flows are subject to changes and fluctuations in the economic conditions in those areas. The local economic conditions in these areas have a significant impact on our commercial real estate, construction and residential real estate loans, the ability of borrowers to repay these loans, and the value of the collateral securing these loans. Adverse changes in the economic conditions in the United States in general, or in our primary markets in Illinois and the State of Illinois in general, could negatively affect our financial condition, results of operations and profitability. While economic conditions in Illinois, along with the U.S. and worldwide, have improved since the end of the economic recession, a return of recessionary conditions could result in the following consequences, any of which could have a material adverse effect on our business:

- loan delinquencies may increase;
- problem assets and foreclosures may increase;
- demand for our products and services may decline; and
- collateral for loans that we make, especially real estate, may decline in value, in turn reducing a customer's borrowing power, and reducing the value of assets and collateral associated with the our loans.

In addition, the State of Illinois continues to experience severe fiscal challenges. Payment lapses by the State of Illinois to its vendors and government sponsored entities may have negative effects on our primary market area. To the extent that these issues, or any future state tax increases, impact the economic vitality of the businesses operating in Illinois, encourage businesses to leave the state or discourage new employers to start or move businesses to Illinois, they could have a material adverse effect on our financial condition and results of operations.

We operate in a highly competitive industry and market area and may face severe competitive disadvantages.

We face substantial competition in all areas of our operations from a variety of different competitors, many of which are larger and have more financial resources. We compete with commercial banks, credit unions, savings and loan associations, mortgage banking firms, other financial service businesses, including investment advisory and wealth management firms, mutual fund companies, and securities brokerage and investment banking firms, as well as super-regional, national and international financial institutions that operate offices in our primary market areas and elsewhere. Recently, local competitors have expanded their presence in the western suburbs of Chicago, including the communities that surround Aurora, Illinois, and these competitors may be better positioned than us to compete for loans, acquisitions and personnel. As customers' preferences and expectations continue to evolve, technology has lowered barriers to entry and made it possible for banks to expand their geographic reach by providing services over the Internet and for non-banks to offer products and services traditionally provided by banks, such as business and

consumer lending, automatic transfer and automatic payment systems. There has also been significant advancement in the exchange of digital assets (“cryptocurrency”) that could materially impact the financial services industry in the future. Because of this rapidly changing technology, our future success will depend in part on our ability to address our customers’ needs by using technology. Customer loyalty can be easily influenced by a competitor’s new products, especially offerings that could provide cost savings or a higher return to the customer. Moreover, the financial services industry could become even more competitive as a result of legislative and regulatory changes, and many large scale competitors can leverage economies of scale to offer better pricing for products and services compared to what we can offer.

We compete with these institutions in attracting deposits and assets under management, processing payment transactions, and in making loans. We may not be able to compete successfully with other financial institutions in our markets, particularly with larger financial institutions operating in our markets that have significantly greater resources than us and offer financial products and services that we are unable to offer, putting us at a disadvantage in competing with them for loans and deposits and wealth management clients, and we may have to pay higher interest rates to attract deposits, accept lower yields on loans to attract loans and pay higher wages for new employees, resulting in lower net interest margin and reduced profitability. In addition, competitors that are not depository institutions are generally not subject to the extensive regulations that apply to us. If we are unable to compete effectively with those banking or other financial services businesses, we could find it more difficult to attract new and retain existing clients and our net interest margins, net interest income and wealth management fees could decline, which would adversely affect our results of operations and could cause us to incur losses in the future.

In addition, our ability to successfully attract and retain wealth management clients is dependent on our ability to compete with competitors’ investment products, level of investment performance, client services and marketing and distribution capabilities. If we are not successful in attracting new and retaining existing clients, our business, financial condition, results of operations and prospects may be materially and adversely affected.

We face a risk of noncompliance with the Bank Secrecy Act and other anti-money laundering statutes and regulations and corresponding enforcement proceedings.

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The federal Bank Secrecy Act, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, or the “PATRIOT Act,” and other laws and regulations require financial institutions, among our other duties, to institute and maintain effective anti-money laundering programs and to file suspicious activity and currency transaction reports as appropriate. The federal Financial Crimes Enforcement Network, established by the U.S. Treasury Department to administer the Bank Secrecy Act, is authorized to impose significant civil money penalties for violations of those requirements and has recently engaged in coordinated enforcement efforts with the individual federal banking regulators, as well as the U.S. Department of Justice, Drug Enforcement Administration and Internal Revenue Service. There is also increased scrutiny of compliance with the rules enforced by the Office of Foreign Assets Control. Federal and state bank regulators also have begun to focus on compliance with Bank Secrecy Act and anti-money laundering regulations. If our policies, procedures and systems are deemed deficient or the policies, procedures and systems of the financial institutions that we have already acquired or may acquire in the future are deficient, we would be subject to liability, including fines and regulatory actions such as restrictions on its ability to pay dividends and the necessity to obtain regulatory approvals to proceed with certain aspects of our business plan, including our acquisition plans, which would negatively impact our business, financial condition and results of operations. Failure to maintain and implement adequate programs to combat money laundering and terrorist financing could also have serious reputational consequences for us.

Our strategic growth plans contemplate additional organic growth and potential growth through additional acquisitions, which exposes us to additional risks.

Our strategic growth plans include organic growth and contemplate growth through additional acquisitions. To the extent that we are unable to increase loans through organic loan growth, or to identify and consummate attractive acquisitions, we may be unable to successfully implement our growth strategy, which could materially and adversely affect our financial condition and earnings.

We routinely evaluate opportunities to acquire additional financial institutions or branches or to open new branches. As a result, we regularly engage in discussions or negotiations that, if they were to result in a transaction, could have a material effect on our operating results and financial condition, including short- and long-term liquidity. Our acquisition activities could require us to use a substantial amount of common stock, cash, other liquid assets, and/or incur debt. In addition, if goodwill recorded in connection with our prior or potential future acquisitions were determined to be impaired, then we would be required to recognize a charge against our earnings, which could materially and adversely affect our results of operations during the period in which the impairment was recognized. Moreover, these types of expansions involve various risks, including:

Management of Growth. We may be unable to successfully:

- maintain loan quality in the context of significant loan growth;
- identify and expand into suitable markets;
- obtain regulatory and other approvals necessary to consummate acquisitions or other expansion activities;
- retain customers of businesses that we acquire;
- attract sufficient deposits and capital to fund anticipated loan growth;
- maintain adequate common equity and regulatory capital;
- avoid diversion or disruption of our management and existing operations as well as those of the acquired institution;
- maintain adequate management personnel and systems to oversee such growth;
- maintain adequate internal audit, risk management, loan review and compliance functions; and
- implement additional policies, procedures and operating systems required to support such growth.

Operating Results. There is no assurance that existing branches or future branches will maintain or achieve deposit levels, loan balances or other operating results necessary to avoid losses or produce profits. Our growth may entail an

increase in overhead expenses as we add new branches and staff. There are considerable costs involved in opening branches, and new branches generally do not generate sufficient revenues to offset their costs until they have been in operation for at least a year or more. Accordingly, any new branches we establish can be expected to negatively impact our earnings for some period of time until they reach certain economies of scale. Our historical results may not be indicative of future results or results that may be achieved, particularly if we continue to expand.

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Failure to successfully address these and other issues related to our expansion could have a material adverse effect on our financial condition and results of operations, and could adversely affect our ability to successfully implement our business strategy.

We are a community bank and our ability to maintain our reputation is critical to the success of our business and the failure to do so may materially adversely affect our performance.

We are a community bank, and our reputation is one of the most valuable components of our business. As such, we strive to conduct our business in a manner that enhances our reputation. This is done, in part, by recruiting, hiring and retaining employees who share our core values: being an integral part of the communities we serve; delivering superior service to our customers; and caring about our customers and associates. Damage to our reputation could undermine the confidence of our current and potential clients in our ability to provide financial services. Such damage could also impair the confidence of our counterparties and business partners, and ultimately affect our ability to effect transactions. Maintenance of our reputation depends not only on our success in maintaining our core values and controlling and mitigating the various risks described herein, but also on our success in identifying and appropriately addressing issues that may arise in areas such as potential conflicts of interest, anti-money laundering, client personal information and privacy issues, record-keeping, regulatory investigations and any litigation that may arise from the failure or perceived failure of us to comply with legal and regulatory requirements. If our reputation is negatively affected, by the actions of our employees or otherwise, our business and, therefore, our operating results may be materially adversely affected. Further, negative public opinion can expose us to litigation and regulatory action as we seek to implement our growth strategy, which could adversely affect our business, financial condition and results of operations.

We are subject to interest rate risk, and a change in interest rates could have a negative effect on our net income.

Our earnings and cash flows are largely dependent upon our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions, our competition and policies of various governmental and regulatory agencies, particularly the Federal Reserve. Changes in monetary policy could influence our earnings. When interest-bearing liabilities mature or reprice more quickly, or to a greater degree than interest-earning assets in a period, an increase in interest rates could reduce net interest income. Similarly, when interest-earning assets mature or reprice more quickly, or to a greater degree than interest-bearing liabilities, falling interest rates could reduce net interest income. Additionally, an increase in the general level of interest rates may also, among other things, adversely affect our current borrower's ability to repay variable rate loans, the demand for loans and our ability to originate loans and decrease loan prepayment rates. Conversely, a decrease in the general level of interest rates, among other things, may lead to increased prepayments on our loan and mortgage-backed securities portfolios and increased competition for deposits. Accordingly, changes in the general level of market interest rates may adversely affect our net yield on interest-earning assets, loan origination volume and our overall results.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations.

Our business needs and future growth may require us to raise additional capital, but that capital may not be available or may be dilutive.

We may need to raise additional capital, in the form of debt or equity securities, in the future to have sufficient capital resources to meet our commitments and fund our business needs and future growth, particularly if the quality of our assets or earnings were to deteriorate significantly. In addition, the Company and the Bank are each required by federal regulatory authorities to maintain adequate levels of capital to support their operations.

Our ability to raise capital will depend on, among other things, conditions in the capital markets, which are outside of our control, and our financial performance. Accordingly, we cannot provide assurance that such capital will be available on terms acceptable to us or at all. Any occurrence that limits our access to capital, may adversely affect our capital costs and our ability to raise capital and, in turn, our liquidity. Further, if we need to raise capital in the future we may have to do so when many other financial institutions are also seeking to raise capital and would then have to compete with those institutions for investors. Any inability to raise capital on acceptable terms when needed could have a material adverse effect on our business, financial condition and results of operations and could be dilutive to both tangible book value and our share price.

In addition, an inability to raise capital when needed may subject us to increased regulatory supervision and the imposition of restrictions on our growth and business. These restrictions could negatively affect our ability to operate or further expand our operations through loan growth, acquisitions or the establishment of additional branches. These restrictions may also result in increases in operating expenses and reductions in revenues that could have a material adverse effect on our financial condition, results of operations and share price.

We could experience an unexpected inability to obtain needed liquidity.

Liquidity measures the ability to meet current and future cash flow needs as they become due. The liquidity of a financial institution reflects its ability to meet loan requests, to accommodate possible outflows in deposits, and to take advantage of interest rate market

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opportunities and is essential to a financial institution's business. The ability of a financial institution to meet its current financial obligations is a function of its balance sheet structure, its ability to liquidate assets and its access to alternative sources of funds. We seek to ensure that our funding needs are met by maintaining an appropriate level of liquidity through asset and liability management. In 2016, the Bank also secured liquidity under the advance program provided under terms offered by the FHLBC. If we are unable to obtain funds when needed, it could have a material adverse effect on its business, financial condition and results of operations.

We may not be able to maintain a strong core deposit base or access other low-cost funding sources.

We rely on bank deposits to be a low cost and stable source of funding. In addition, our future growth will largely depend on our ability to maintain and grow a strong deposit base. If we are unable to continue to attract and retain core deposits, to obtain third party financing on favorable terms, or to have access to interbank or other liquidity sources, we may not be able to grow our assets as quickly. We compete with banks and other financial services companies for deposits. If our competitors raise the rates they pay on deposits in response to interest rate changes initiated by the FRBC Open Market Committee or for other reasons of their choice, our funding costs may increase, either because we raise our rates to avoid losing deposits or because we lose deposits and must rely on more expensive sources of funding. Higher funding costs could reduce our net interest margin and net interest income. Any decline in available funding could adversely affect our ability to continue to implement our business strategy which could have a material adverse effect on our liquidity, business, financial condition and results of operations.

Our estimate of fair values for our investments may not be realizable if we were to sell these securities today.

Our available-for-sale securities are carried at fair value.

The determination of fair value for securities categorized in Level 3 involves significant judgment due to the complexity of the factors contributing to the valuation, many of which are not readily observable in the market. Recent market disruptions and the resulting fluctuations in fair value have made the valuation process even more difficult and subjective. If the valuations are incorrect, it could harm our financial results and financial condition.

We may be materially and adversely affected by the highly regulated environment in which we operate.

We are subject to extensive federal and state regulation, supervision and examination. Banking regulations are primarily intended to protect depositors' funds, FDIC funds, customers and the banking system as a whole, rather than our stockholders. Compliance with banking regulations is costly and these regulations affect our lending practices,

capital structure, investment practices, mergers and acquisitions, dividend policy, and growth, among other things.

The Company and the Bank also undergo periodic examinations by their regulators, who have extensive discretion and authority to prevent or remedy unsafe or unsound practices or violations of law. Failure to comply with applicable laws, regulations or policies could result in sanctions by regulatory agencies, civil monetary penalties, and/or damage to our reputation, which could have a material adverse effect on our business, financial condition or results of operations.

A more detailed description of the primary federal and state banking laws and regulations that affect the Company and the Bank is included in this Form 10-K under the section captioned "Supervision and Regulation" in Item 1. Since the economic recession, federal and state banking laws and regulations, as well as interpretations and implementations of these laws and regulations, have undergone substantial review and change. In particular, the Dodd-Frank Act drastically revised the laws and regulations under which we operate. The burden of regulatory compliance has increased under the Dodd-Frank Act and has increased our costs of doing business and, as a result, may create an advantage for our competitors who may not be subject to similar legislative and regulatory requirements. Regulations and laws may be modified at any time, and new legislation may be enacted that will affect us. Any future changes in federal and state laws and regulations, as well as the interpretation and implementation of such laws and regulations, could affect us in substantial and unpredictable ways, including those listed above or other ways that could have a material adverse effect on our business, financial condition or results of operations.

Monetary policies and regulations of the Federal Reserve could adversely affect our business, financial condition and results of operations.

In addition to being affected by general economic conditions, our earnings and growth are affected by the policies of the Federal Reserve. An important function of the Federal Reserve is to regulate the money supply and credit conditions. Among the instruments used by the Federal Reserve to implement these objectives are open market purchases and sales of U.S. government securities, adjustments of the discount rate and changes in banks' reserve requirements against bank deposits. These instruments are used in varying combinations to influence overall economic growth and the distribution of credit, bank loans, investments and deposits. Their use also affects interest rates charged on loans or paid on deposits.

The monetary policies and regulations of the Federal Reserve have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future. The effects of such policies upon our business, financial condition and results of operations cannot be predicted.

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Our accounting estimates and risk management processes and controls rely on analytical and forecasting techniques and models and assumptions, which may not accurately predict future events.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. Our management must exercise judgment in selecting and applying many of these accounting policies and methods so they comply with GAAP and reflect management's judgment of the most appropriate manner in which to report our financial condition and results. In some cases, management must select the accounting policy or method to apply from two or more alternatives, any of which may be reasonable under the circumstances, yet which may result in our reporting materially different results than would have been reported under a different alternative.

Certain accounting policies are critical to presenting our financial condition and results of operations. They require management to make difficult, subjective or complex judgments about matters that are uncertain. Materially different amounts could be reported under different conditions or using different assumptions or estimates. These critical accounting policies include the allowance for loan and lease losses; the fair value of securities, acquired assets and liabilities, including the valuation of intangible assets; off-balance sheet financial instruments; and the accounting for income taxes. Because of the uncertainty of estimates involved in these matters, we may be required to significantly increase the allowance for loan and lease losses or sustain loan losses that are significantly higher than the reserve provided, reduce the carrying value of an asset measured at fair value, or significantly increase liabilities measured at fair value or our accrued tax liability. Any of these could have a material adverse effect on our business, financial condition or results of operations. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Our internal controls, disclosure controls, processes and procedures, and corporate governance policies and procedures are based in part on certain assumptions and can provide only reasonable (not absolute) assurances that the objectives of the system are met. Any failure or circumvention of our controls, processes and procedures or failure to comply with regulations related to controls, processes and procedures could necessitate changes in those controls, processes and procedures, which may increase our compliance costs, divert management attention from our business or subject us to regulatory actions and increased regulatory scrutiny. Any of these could have a material adverse effect on our business, financial condition or results of operations.

Our deposit insurance premiums could be substantially higher in the future, which could have a material adverse effect on our future earnings.

The FDIC insures deposits at FDIC-insured depository institutions, such as the Bank, up to \$250,000 per insured depositor category. The amount of a particular institution's deposit insurance assessment is based on that institution's risk classification under an FDIC risk-based assessment system. An institution's risk classification is assigned based on its capital levels and the level of supervisory concern the institution poses to its regulators. As a result of recent FDIC assessment charges, banks are now assessed deposit insurance premiums based on the bank's average consolidated total assets less the sum of its average tangible equity, and the FDIC has modified certain risk-based

adjustments, which increase or decrease a bank's overall assessment rate. This has resulted in increases to the deposit insurance assessment rates and thus raised deposit premiums for many insured depository institutions. If these increases are insufficient for the Deposit Insurance Fund to meet its funding requirements, further special assessments or increases in deposit insurance premiums may be required. We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional bank or financial institution failures, we may be required to pay higher FDIC premiums than the recent levels. Any future additional assessments, increases or required prepayments in FDIC insurance premiums could reduce our profitability, may limit our ability to pursue certain business opportunities or otherwise negatively impact our operations.

We are subject to federal and state fair lending laws, and failure to comply with these laws could lead to material penalties.

Federal and state fair lending laws and regulations, such as the Equal Credit Opportunity Act and the Fair Housing Act, impose nondiscriminatory lending requirements on financial institutions. The Department of Justice, the Consumer Financial Protection Bureau and other federal and state agencies are responsible for enforcing these laws and regulations. Private parties may also have the ability to challenge an institution's performance under fair lending laws in private class action litigation. A successful challenge to our performance under the fair lending laws and regulations could adversely impact our rating under the Community Reinvestment Act and result in a wide variety of sanctions, including the required payment of damages and civil money penalties, injunctive relief, imposition of restrictions on merger and acquisition activity and restrictions on expansion activity, which could negatively impact our reputation, business, financial condition and results of operations.

New lines of business, products, product enhancements or services may subject us to additional risks.

From time to time, we may implement new lines of business or offer new products, and product enhancements as well as new services within our existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances in which the markets are not fully developed. In implementing, developing or marketing new lines of business, products, product enhancements or services, we may invest significant time and resources, although we may not assign the appropriate level of resources or expertise necessary to make these new lines of business, products, product enhancements or services successful or to realize their expected benefits. Further, initial timetables for the introduction and development of new lines of business, products, product

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enhancements or services may not be achieved, and price and profitability targets may not prove feasible. The introduction of such new products requires continued innovative efforts on the part of our management and may require significant time and resources as well as ongoing support and investment. External factors, such as compliance with regulations, competitive alternatives and shifting market preferences, may also affect the ultimate implementation of a new line of business or offerings of new products, product enhancements or services. Furthermore, any new line of business, product, product enhancement or service or system conversion could have a significant impact on the effectiveness of our system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or offerings of new products, product enhancements or services could have a material adverse effect on our business, financial condition or results of operations.

Our ability to realize our deferred tax asset may be reduced, which may adversely impact our results of operations.

Deferred tax assets are reported as assets on our balance sheet and represent the decrease in taxes expected to be paid in the future because of net operating losses (“NOLs”) and tax credit carryforwards and because of future reversals of temporary differences in the bases of assets and liabilities as measured by enacted tax laws and their bases as reported in the financial statements. As of December 31, 2018, we had net deferred tax assets of \$21.3 million, which included deferred tax assets for a federal net operating loss carryforward of \$2.2 million that is expected to expire in 2031 thru 2033. Realization of deferred tax assets is dependent upon the generation of sufficient future taxable income during the periods in which existing deferred tax assets are expected to become deductible for income tax purposes. Based on projections of future taxable income in periods in which deferred tax assets are expected to become deductible, management determined that the realization of our net deferred tax asset was more likely than not. As a result, we did not recognize a valuation allowance on our net deferred tax asset as of December 31, 2018 or December 31, 2017. If it becomes more likely than not that some portion or the entire deferred tax asset will not be realized, a valuation allowance must be recognized. In July 2017, the State of Illinois enacted an income tax rate increase which resulted in us recording an additional income tax benefit and increase to the deferred tax asset of \$1.6 million. In December 2017, the Tax Cuts and Jobs Act was enacted, which reduced the corporate federal income tax rate to 21% and resulted in a \$9.5 million write-down of our deferred tax asset in the fourth quarter of 2017, through income tax expense. These tax rate changes, in conjunction with our net income in 2017 and 2018, have resulted in a significant reduction of the deferred tax asset over the last two years. Our deferred tax asset may be further reduced in the future if estimates of future income or our tax planning strategies do not support the amount of the deferred tax assets. Charges to establish a valuation allowance with respect to our deferred tax asset could have a material adverse effect on our financial condition and results of operations.

We could become subject to claims and litigation pertaining to our fiduciary responsibility.

Some of the services we provide, such as wealth management services through River Street Advisors, LLC, require us to act as fiduciaries for our customers and others. Customers make claims and on occasion take legal action pertaining to our performance of our fiduciary responsibilities. Whether customer claims and legal action related to our performance of our fiduciary responsibilities are founded or unfounded, if such claims and legal action are not resolved in a manner favorable to us, they may result in significant financial liability and/or adversely affect the market perception of us and our products and services as well as impact customer demand for those products and services. Any financial liability or reputational damage could have a material adverse effect on our business, which,

in turn, could have a material adverse impact on our financial condition and results of operations.

Our trust and wealth management business may be negatively impacted by changes in economic and market conditions and clients may seek legal remedies for investment performance.

Our trust and wealth management business may be negatively impacted by changes in general economic and market conditions because the performance of this businesses is directly affected by conditions in the financial and securities markets. The financial markets and businesses operating in the securities industry are highly volatile (meaning that performance results can vary greatly within short periods of time) and are directly affected by, among other factors, domestic and foreign economic conditions and general trends in business and finance, and by the threat, as well as the occurrence of global conflicts, all of which are beyond our control. We cannot assure you that broad market performance will be favorable in the future. Declines in the financial markets or a lack of sustained growth may result in a decline in the performance of our wealth management business and may adversely affect the market value and performance of the investment securities that we manage, which could lead to reductions in our wealth management fees, because they are based primarily on the market value of the securities we manage, and could lead some of our clients to reduce their assets under management by us or seek legal remedies for investment performance. If any of these events occur, the financial performance of our wealth management business could be materially and adversely affected.

We depend on our executive officers and other key employees, and our ability to attract additional key personnel, to continue the implementation of our long-term business strategy, and we could be harmed by the unexpected loss of their services.

We believe that our continued growth and future success will depend in large part on the skills of our executive officers and other key employees and our ability to motivate and retain these individuals, as well as our ability to attract, motivate and retain highly qualified senior and middle management and other skilled employees. Our business is primarily relationship-driven in that many of our key personnel have extensive customer or asset management relationships. Loss of key personnel with such relationships may lead to the loss of business if the customers were to follow that employee to a competitor or if asset management expertise was not replaced in a

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timely manner. Competition for employees is intense, and the process of locating key personnel with the combination of skills and attributes required to execute our business strategy may be lengthy. We may not be successful in retaining key personnel, and the unexpected loss of services of one or more of our key personnel could have a material adverse effect on our business because of their skill, knowledge of our primary markets, years of industry experience and the difficulty of promptly finding qualified replacement personnel. If the services of any of our key personnel should become unavailable for any reason, we may not be able to identify and hire qualified persons on terms acceptable to the Company, or at all, which could have a material adverse effect on our business, financial condition, results of operation and future prospects.

Our information systems may experience an interruption or breach in security and cyber-attacks, all of which could have a material adverse effect on our business.

We rely heavily on internal and outsourced technologies, communications, and information systems to conduct our business. Additionally, in the normal course of business, we collect, process and retain sensitive and confidential information regarding our customers. As our reliance on technology has increased, so have the potential risks of a technology-related operation interruption (such as disruptions in our customer relationship management, general ledger, deposit, loan, or other systems) or the occurrence of a cyber-attack (such as unauthorized access to our systems). These risks have increased for all financial institutions as new technologies have emerged, including the use of the Internet and the expansion of telecommunications technologies (including mobile devices) to conduct financial and other business transactions, and as the sophistication of organized criminals, perpetrators of fraud, hackers, terrorists and others have increased.

In addition to cyber-attacks or other security breaches involving the theft of sensitive and confidential information, hackers recently have engaged in attacks against large financial institutions, particularly denial of service attacks that are designed to disrupt key business services, such as customer-facing web sites. We operate in an industry where otherwise effective preventive measures against security breaches become vulnerable as breach strategies change frequently and cyber-attacks can originate from a wide variety of sources. It is possible that a cyber incident, such as a security breach, may be undetected for a period of time. However, applying guidance from the Federal Financial Institutions Examination Council, we have identified security risks and employ risk mitigation controls. Following a layered security approach, we have analyzed and will continue to analyze security related to device specific considerations, user access topics, transaction-processing and network integrity. We expect that we will spend additional time and will incur additional cost going forward to modify and enhance protective measures and that effort and spending will continue to be required to investigate and remediate any information security vulnerabilities.

We also face risks related to cyber-attacks and other security breaches in connection with credit card and debit card transactions that typically involve the transmission of sensitive information regarding our customers through various third parties, including merchant-acquiring banks, payment processors, payment card networks and their processors. Some of these parties have in the past been the target of security breaches and cyber-attacks. Because these third parties and related environments such as the point-of-sale are not under our direct control, future security breaches or cyber-attacks affecting any of these third parties could impact us and in some cases we may have exposure and suffer losses for breaches or attacks. We offer our customers protection against fraud and attendant losses for

unauthorized use of debit cards in order to stay competitive in the market place. Offering such protection exposes us to potential losses which, in the event of a data breach at one or more retailers of considerable magnitude, may adversely affect our business, financial condition, and results of operation. Further cyber-attacks or other breaches in the future, whether affecting us or others, could intensify consumer concern and regulatory focus and result in reduced use of payment cards and increased costs, all of which could have a material adverse effect on our business. To the extent we are involved in any future cyber-attacks or other breaches, our reputation could be affected which may have a material adverse effect on our business, financial condition or results of operations.

We depend on outside third parties for the processing and handling of our records and data.

We rely on software developed by third party vendors to process various Company transactions. In some cases, we have contracted with third parties to run their proprietary software on behalf of the Company at a location under the control of the third party. These systems include, but are not limited to, core data processing, payroll, wealth management record keeping, and securities portfolio management. While we perform a review of controls instituted by the vendor over these programs in accordance with industry standards and institute our own user controls, we must rely on the continued maintenance of the performance controls by these outside parties, including safeguards over the security of customer data. In addition, we create backup copies of key processing output daily in the event of a failure on the part of any of these systems. Nonetheless, we may incur a temporary disruption in our ability to conduct our business or process our transactions, or incur damage to our reputation if a third party vendor fails to adequately maintain internal controls or institute necessary changes to systems. A disruption or breach of security may ultimately have a material adverse effect on our financial condition and results of operations.

Our use of third party vendors and our other ongoing third party business relationships are subject to increasing regulatory requirements and attention.

We regularly use third party vendors as part of our business. We also have substantial ongoing business relationships with other third parties. These types of third party relationships are subject to increasingly demanding regulatory requirements and attention by our federal bank regulators. Recent regulation requires us to enhance our due diligence, ongoing monitoring and control over our third

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party vendors and other ongoing third party business relationships. We expect that our regulators will hold us responsible for deficiencies in our oversight and control of our third party relationships and in the performance of the parties with which we have these relationships. As a result, if our regulators conclude that we have not exercised adequate oversight and control over our third party vendors or other ongoing third party business relationships or that such third parties have not performed appropriately, we could be subject to enforcement actions, including civil money penalties or other administrative or judicial penalties or fines as well as requirements for customer remediation, any of which could have a material adverse effect our business, financial condition or results of operations.

We are at risk of increased losses from fraud.

Criminals committing fraud increasingly are using more sophisticated techniques and in some cases are part of larger criminal rings, which allow them to be more effective.

The fraudulent activity has taken many forms, ranging from check fraud, mechanical devices attached to ATM machines, social engineering and phishing attacks to obtain personal information or impersonation of our clients through the use of falsified or stolen credentials. Additionally, an individual or business entity may properly identify themselves, particularly when banking online, yet seek to establish a business relationship for the purpose of perpetrating fraud. Further, in addition to fraud committed against us, we may suffer losses as a result of fraudulent activity committed against third parties. Increased deployment of technologies, such as chip card technology, defray and reduce aspects of fraud; however, criminals are turning to other sources to steal personally identifiable information, such as unaffiliated healthcare providers and government entities, in order to impersonate the consumer to commit fraud. Many of these data compromises are widely reported in the media. Further, as a result of the increased sophistication of fraud activity, we have increased our spending on systems and controls to detect and prevent fraud. This will result in continued ongoing investments in the future.

We are defendants in a variety of litigation and other actions.

Currently, there are certain other legal proceedings pending against the Company and our subsidiaries in the ordinary course of business. While the outcome of any legal proceeding is inherently uncertain, based on information currently available, the Company's management believes that any liabilities arising from pending legal matters would not have a material adverse effect on us or our consolidated financial statements. However, if actual results differ from management's expectations, it could have a material adverse effect on our financial condition, results of operations, or cash flows.

Risks Associated with the Company's Common Stock

Our future ability to pay dividends is subject to restrictions.

We currently conduct substantially all of our operations through our subsidiaries, and a significant part of our income is attributable to dividends from the Bank and we principally rely on the profitability of the Bank to conduct operations and satisfy obligations. As is the case with all financial institutions, the profitability of the Bank is subject to the fluctuating cost and availability of money, changes in interest rates, and in economic conditions in general. In addition, various federal and state statutes and regulations limit the amount of dividends that the Bank may pay to us, with or without regulatory approval.

Holders of our common stock are entitled to receive only such cash dividends as our board of directors may declare out of funds legally available for such payments. Any declaration and payment of dividends on common stock will depend upon our earnings and financial condition, liquidity and capital requirements, the general economic and regulatory climate, our ability to service any equity or debt obligations senior to the common stock, and other factors deemed relevant by the board of directors. Furthermore, consistent with our business plans, growth initiatives, capital availability, projected liquidity needs, and other factors, we have made, and will continue to make, capital management decisions and policies that could adversely impact the amount of dividends, if any, paid to our stockholders.

Although we currently expect to continue to pay quarterly dividends, any future determination relating to our dividend policy will be made by our board of directors and will depend on a number of factors. We are subject to certain restrictions on the payment of cash dividends as a result of banking laws, regulations and policies. Finally, our ability to pay dividends to our stockholders depends on our receipt of dividends from the Bank, which is also subject to restrictions on dividends as a result of banking laws, regulations and policies. See Part II, Item 5. "Dividend Policy."

The trading volumes in our common stock may not provide adequate liquidity for investors.

Shares of our common stock are listed on the NASDAQ Global Select Market; however, the average daily trading volume in our common stock is less than that of most larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of a sufficient number of willing buyers and sellers of the

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common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the current daily average trading volume of our common stock, significant sales of our common stock in a brief period of time, or the expectation of these sales, could cause a significant decline in the price of our common stock.

The trading price of our common stock may be subject to continued significant fluctuations and volatility.

The market price of our common stock could be subject to significant fluctuations due to, among other things:

- actual or anticipated quarterly fluctuations in our operating and financial results, particularly if such results vary from the expectations of management, securities analysts and investors, including with respect to further loan and lease losses we may incur;
- announcements regarding significant transactions in which we may engage;
- market assessments regarding such transactions;
- changes or perceived changes in our operations or business prospects;
- legislative or regulatory changes affecting our industry generally or our businesses and operations;
- a weakening of general market and economic conditions, particularly with respect to economic conditions in Illinois;
- the operating and share price performance of companies that investors consider to be comparable to us;
- future offerings by us of debt, preferred stock or trust preferred securities, each of which would be senior to our common stock upon liquidation and for purposes of dividend distributions;
- actions of our current stockholders, including future sales of common stock by existing stockholders and our directors and executive officers; and
- other changes in U.S. or global financial markets, economies and market conditions, such as interest or foreign exchange rates, stock, commodity, credit or asset valuations or volatility.

Stock markets in general, and financial institutions in particular, have experienced significant volatility beginning in the fourth quarter of 2018. As a result, the market price of our common stock may continue to be subject to similar market fluctuations that may or may not be related to our operating performance or prospects. Increased volatility could result in a decline in the market price of our common stock.

Shares of our common stock are subject to dilution, which could cause our common stock price to decline.

We are generally not restricted from issuing additional shares of our common stock up to the number of shares authorized in our Certificate of Incorporation. We may issue additional shares of our common stock (or securities convertible into common stock) in the future for a number of reasons, including to finance our operations and business strategy (including mergers and acquisitions), to adjust our ratio of debt to equity, to address regulatory capital concerns, or to satisfy our obligations upon the exercise of outstanding options. We may issue equity securities in transactions that generate cash proceeds, transactions that free up regulatory capital but do not immediately generate or preserve substantial amounts of cash, and transactions that generate regulatory or balance sheet capital only and do

not generate or preserve cash. If we choose to raise capital by selling shares of our common stock or securities convertible into common stock for any reason, the issuance would have a dilutive effect on the holders of our common stock and could have a material negative effect on the market price of our common stock.

Certain banking laws and our governing documents may have an anti-takeover effect.

Certain federal banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire us, even if doing so would be perceived to be beneficial to our stockholders. In addition, we have a classified board of directors, and our Certificate of Incorporation requires the approval of certain business combinations by at least 75% of our outstanding shares of common stock. The combination of these laws, the board structure and the business combination provision in our Certificate of Incorporation may inhibit certain business combinations, including a non-negotiated merger or other business combination, which, in turn, could adversely affect the market price of our common stock.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

We conduct our business primarily at 29 banking locations in various communities throughout the greater western and southern Chicago metropolitan area. The principal business office of the Company is located at 37 South River Street, Aurora, Illinois. We own 26 of our properties and lease three of our locations. The Company's three leased locations are under agreement through

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March 31, 2019, August 31, 2019, and March 31, 2022. We believe that all of our properties and equipment are well maintained, in good operating condition and adequate for all of our present and anticipated needs.

Item 3. Legal Proceedings

The Company and its subsidiaries have, from time to time, collection suits and other actions that arise in the ordinary course of business against its borrowers and are defendants in legal actions arising from normal business activities. Management, after consultation with legal counsel, believes that the ultimate liabilities, if any, resulting from these actions will not have a material adverse effect on the financial position of the Bank or on the consolidated financial position of the Company.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market for the Company’s Common Stock

Our common stock trades on the NASDAQ Global Select Market under the symbol “OSBC.” As of December 31, 2018, we had 858 stockholders of record for our common stock. The following table sets forth the high and low trading prices of our common stock on the NASDAQ Global Select Market, and information about declared dividends during each quarter for 2018 and 2017.

	2018			2017		
	High	Low	Dividend	High	Low	Dividend
First quarter	\$ 15.00	\$ 13.10	\$ 0.01	\$ 11.50	\$ 9.65	\$ 0.01

Second quarter	15.60	13.45	0.01	12.75	10.95	0.01
Third quarter	16.30	14.35	0.01	13.50	10.75	0.01
Fourth quarter	15.61	11.32	0.01	14.90	12.15	0.01

Dividend Policy

The Company's stockholders are entitled to receive dividends when, as and if declared by the board of directors out of funds legally available therefor. The Company's ability to pay dividends to stockholders is largely dependent upon the dividends it receives from the Bank; however, certain regulatory restrictions and the terms of its debt and equity securities, limit the amount of cash dividends it may pay. See "Supervision and Regulation—Regulation and Supervision of the Bank."

Although we currently expect to continue to pay quarterly dividends, any future determination relating to our dividend policy will be made by our board of directors and will depend on a number of factors, including: (1) our historic and projected financial condition, liquidity and results of operations, (2) our capital levels and needs, (3) tax considerations, (4) any acquisitions or potential acquisitions that we may examine, (5) statutory and regulatory prohibitions and other limitations, (6) the terms of any credit agreements or other borrowing arrangements that restrict our ability to pay cash dividends, (7) general economic conditions and (8) other factors deemed relevant by our board of directors. We are not obligated to pay dividends on our common stock and are subject to restrictions on paying dividends on our common stock.

As a Delaware corporation, we are subject to certain restrictions on dividends under the Delaware General Corporation Law (the "DGCL"). Generally, a Delaware corporation may only pay dividends either out of surplus or out of the current or the immediately preceding year's net profits. Surplus is defined as the excess, if any, at any given time, of the total assets of a corporation over its total liabilities and statutory capital. The value of a corporation's assets can be measured in a number of ways and may not necessarily equal their book value.

In addition, we are subject to certain restrictions on the payment of cash dividends as a result of banking laws, regulations and policies. See "Supervision and Regulation—Regulation and Supervision of the Company."

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Recent Sales of Unregistered Securities

None.

Form 10-K and Other Information

Transfer Agent/Stockholder Services

Inquiries related to stockholders records, stock transfers, changes of ownership, change of address and dividend payments should be sent to the transfer agent at the following address:

Old Second Bancorp, Inc.

c/o Shirley Cantrell,

Shareholder Relations Department

37 South River Street

Aurora, Illinois 60507

(630) 906-2303

scantrell@oldsecond.com

Stockholder Return Performance Graph. The following graph indicates, for the period commencing December 31, 2013, and ending December 31, 2018, a comparison of cumulative total returns for the Company, S&P 500 and the SNL U.S. Bank NASDAQ. The information assumes that \$100 was invested at the closing price at December 31, 2013, in the common stock of the Company and each index and that all dividends were reinvested.

Index	Period Ending					
	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018
Old Second Bancorp, Inc.	100.00	116.23	169.70	240.13	297.63	284.24
S&P 500	100.00	113.69	115.26	129.05	157.22	150.33
SNL U.S. Bank NASDAQ	100.00	103.57	111.80	155.02	163.20	137.56

Purchases of Equity Securities By the Issuer and Affiliated Purchasers

None.

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Item 6. Selected Financial Data

Old Second Bancorp, Inc. and Subsidiaries

Financial Highlights

(In thousands, except share data)

	2018	2017	2016	2015	2014
Balance sheet items at year-end					
Total assets	\$ 2,676,003	\$ 2,383,429	\$ 2,251,188	\$ 2,077,028	\$ 2,060,905
Total earning assets	2,471,328	2,191,685	2,037,012	1,862,257	1,832,714
Average assets	2,547,806	2,318,798	2,142,748	2,065,122	2,036,493
Loans, gross	1,897,027	1,617,622	1,478,809	1,133,715	1,159,332
Allowance for loan and lease losses	19,006	17,461	16,158	16,223	21,637
Deposits	2,116,673	1,922,925	1,866,785	1,759,086	1,685,055
Securities sold under agreement to repurchase	46,632	29,918	25,715	34,070	21,036
Other short-term borrowings	149,500	115,000	70,000	15,000	45,000
Junior subordinated debentures	57,686	57,639	57,591	57,543	57,496
Senior notes	44,158	44,058	43,998	-	-
Subordinated debt	-	-	-	45,000	45,000
Note payable	15,379	-	-	500	500
Stockholders' equity	229,081	200,350	175,210	155,929	194,163
Results of operations for the year ended					
Interest and dividend income	107,617	87,505	73,379	68,164	68,044
Interest expense	16,678	12,626	9,938	9,076	10,984
Net interest and dividend income	90,939	74,879	63,441	59,088	57,060
Provision (release) for loan and lease losses	1,228	1,800	750	(4,400)	(3,300)
Noninterest income	31,353	30,372	28,574	29,294	29,216
Noninterest expense	77,128	69,149	66,761	68,421	73,679
Income before taxes	43,936	34,302	24,504	24,361	15,897
Provision for income taxes	9,924	19,164	8,820	8,976	5,761

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Net income	34,012		15,138		15,684		15,385		10,136	
Preferred stock dividends and accretion	-		-		-		1,873		(1,719)	
Net income available to common stockholders	\$ 34,012		\$ 15,138		\$ 15,684		\$ 13,512		\$ 11,855	
Loan quality ratios										
Allowance for loan and lease losses to total loans at end of year	1.00	%	1.08	%	1.09	%	1.43	%	1.87	%
Provision (release) for loan and lease losses to total loans	0.06	%	0.11	%	0.05	%	(0.39)	%	(0.28)	%
Net loans (recovered) charged-off to average total loans	(0.02)	%	0.03	%	0.07	%	0.09	%	0.21	%
Nonaccrual loans to total loans at end of year	0.72	%	0.89	%	1.03	%	1.27	%	2.32	%
Nonperforming assets to total assets at end of year	0.88	%	1.01	%	1.24	%	1.63	%	2.87	%
Allowance for loan and lease losses to nonaccrual loans	138.32	%	121.36	%	105.73	%	112.75	%	80.36	%
Per share data										
Basic earnings	\$ 1.14		\$ 0.51		\$ 0.53		\$ 0.46		\$ 0.46	
Diluted earnings	1.12		0.50		0.53		0.46		0.46	
Common book value per share	7.70		6.76		5.93		5.29		4.99	
Weighted average diluted shares outstanding	30,308,935		30,038,417		29,838,931		29,730,074		25,549,193	
Weighted average basic shares outstanding	29,728,308		29,600,702		29,532,510		29,476,821		25,300,909	
Shares outstanding at year-end	29,763,078		29,627,086		29,556,216		29,483,429		29,442,508	

The following represents unaudited quarterly financial information for the periods indicated:

	2018				2017			
	4th	3rd	2nd	1st	4th	3rd	2nd	1st
Interest income	\$ 29,038	\$ 28,176	\$ 27,261	\$ 23,142	\$ 22,664	\$ 22,425	\$ 21,800	\$ 20,616
Interest expense	4,698	4,436	4,019	3,526	3,278	3,142	3,139	3,067

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Net interest income	24,340	23,740	23,242	19,616	19,386	19,283	18,661	17,549
Loan loss (release) reserve	500	-	1,450	(722)	750	300	750	-
Securities gains (losses), net	-	13	312	35	639	102	(131)	(136)
Income before taxes	11,565	12,843	8,038	11,489	10,629	9,908	7,242	6,523
Net income (loss)	8,620	9,642	6,261	9,489	(2,512)	8,077	5,146	4,427
Basic earnings (losses) per share	0.29	0.32	0.21	0.32	(0.08)	0.27	0.17	0.15
Diluted earnings (losses) per share	0.28	0.32	0.21	0.31	(0.08)	0.27	0.17	0.15
Dividends paid per share	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion provides additional information regarding our operations for the twelve-month periods ending December 31, 2018, 2017 and 2016, and financial condition at December 31, 2018 and 2017. This discussion should be read in conjunction with "Selected Financial Data" and our consolidated financial statements and the accompanying notes thereto included elsewhere in this report. We have made, and will continue to make, various forward-looking statements with respect to financial and business matters. Comments regarding our business that are not historical facts are considered forward-looking statements that involve inherent risks and uncertainties. Actual results may differ materially from those contained in these forward-looking statements. For additional information regarding our cautionary disclosures, see the "Cautionary Note Regarding Forward-Looking Statements" at the beginning of this annual report.

Business overview

We provide a wide range of financial services through our 29 banking locations located in Cook, DeKalb, DuPage, Kane, Kendall, LaSalle and Will counties in Illinois. These banking centers offer access to a full range of traditional retail and commercial banking services including treasury management operations as well as fiduciary and wealth management services. We focus our business on establishing and maintaining relationships with our clients while maintaining a commitment to providing for the financial services needs of the communities in which we operate through our retail branch network. We emphasize relationships with individual customers as well as small to medium-sized businesses throughout our market area. Our market area includes a mix of commercial and industrial, real estate, and consumer related lending opportunities, and provides a stable, loyal core deposit base. We also offer extensive wealth management services, which include a registered investment advisory platform in addition to trust administration and trust services related to personal and corporate trusts, including employee benefit plan administration services.

Our primary deposit products are checking, NOW, money market, savings, and certificate of deposit accounts, and our primary lending products are commercial mortgages, construction lending, commercial loans, residential mortgages, leases and consumer loans. Many of our loans are secured by various forms of collateral including real estate, business assets, and consumer property although borrower cash flow is the primary source of repayment at the time of loan origination.

The health of the overall real estate industry in our markets continued to improve in 2018. While the precipitous decline in the value of certain real estate assets slowed in the latter part of 2010, continued difficult market conditions through 2015 generated smaller declines in values of real estate and associated asset types. Overall stable market conditions over the past three years are reflected in the financials presented for the reporting period that ended December 31, 2018.

On April 20, 2018, we closed on our acquisition of Greater Chicago Financial Corp. (“GCFC”), and its wholly-owned subsidiary, ABC Bank. As a result of this transaction, we acquired \$227.6 million of loans, net of fair value adjustments, and \$248.5 million of deposits, net of fair value adjustments. The purchase resulted in us increasing our presence in the near west Chicago area and metropolitan Chicago, as four branches were acquired with a retail and commercial client mix of loans and deposits.

On October 28, 2016, we closed on our acquisition of the Chicago branch of Talmer Bank and Trust, the banking subsidiary of Talmer Bancorp, Inc. (“Talmer”). As a result of this transaction, we acquired \$221.0 million of loans and \$48.9 million of deposits, both net of fair value adjustments. The purchase resulted in us establishing a metropolitan Chicago office presence with a strong commercial client focus, and retention of an experienced lending team.

Financial overview

In 2018, we recorded net income of \$34.0 million, or \$1.12 per fully diluted share, which compares with \$15.1 million, or \$0.50 per fully diluted share in 2017, and \$15.7 million, or \$0.53 per fully diluted share in 2016. Our basic earnings per share for the periods presented were \$1.14 in 2018, \$0.51 in 2017 and \$0.53 in 2016. Our 2018 net income increased primarily due to the expansion of net interest margin driven by loans acquired in 2018 as well as organic loan growth and rising interest rates, improved operating leverage, and a reduction in income taxes due the “Tax Cuts and Jobs Act” enacted in December 2017. Our 2017 net income was negatively impacted by a nonrecurring income tax expense of \$9.5 million recorded in the fourth quarter of 2017 due to the “Tax Cuts and Jobs Act,” signed into law in late 2017, which reduced the federal income tax rate and decreased our deferred tax asset. Our 2017 net income was favorably impacted by a nonrecurring income tax credit of \$1.6 million recorded in July 2017 due to a State of Illinois tax rate increase, which increased the deferred tax asset by a like amount. In addition, we recorded a provision for loan and lease losses in 2018 of \$1.2 million compared to \$1.8 million and \$750,000 in 2017 and 2016, respectively. Net loan recoveries were \$317,000 in 2018, and loan charge-offs were \$497,000 and \$815,000 in 2017 and 2016, respectively.

Net interest and dividend income increased \$16.1 million, or 21.4%, for 2018, compared to 2017. Average loans, including loans held-for-sale, increased \$241.3 million, or 15.7%, in 2018 compared to 2017. The ABC Bank acquisition in the second quarter of 2018 and two select HELOC loan purchases in the first and fourth quarters of 2018 contributed to the full year 2018 average loan growth. We also had organic loan growth in all areas of our loan portfolios in 2018 compared to 2017. Average interest bearing deposits increased \$123.1 million, or 9.1%, for 2018 compared to 2017, while average deposit rates increased 16 basis points. This increase was primarily

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due to the rising interest rate environment, impacting interest rates on all interest bearing deposit categories. Average noninterest bearing deposits increased by \$61.0 million, or 11.1%, from 2017 to 2018, a result of commercial demand deposit growth which correlated with the increase in commercial, construction, and commercial real estate loan growth.

Net interest and dividend income increased \$11.4 million, or 18.0%, for 2017, compared to 2016. Average loans, including loans held-for-sale, increased \$318.8 million, or 26.2%, in 2017 compared to 2016. The Talmer branch acquisition in the fourth quarter of 2016 contributed to the full year 2017 average loan growth, with additional growth realized primarily in the commercial and commercial real estate loan portfolios. Average interest bearing deposits increased \$32.4 million, or 2.5%, while average rates increased five basis points. This increase was primarily due to rising rates offered on time or certificates of deposit. Average noninterest bearing deposits increased by \$71.3 million, or 15.0%, from 2016 to 2017, a result of commercial demand deposit growth which correlated with our increased commercial loan growth.

In 2017 and 2018, we continued to reposition our balance sheet to provide appropriate funding for loan growth and branch acquisition needs, to further reduce asset quality risk, and grow deposits organically as a less expensive funding source. In 2017, we repositioned our available-for sale securities portfolio into higher-yielding state and political subdivisions from mortgage-backed securities (“MBS”) and collateralized mortgage obligations (“CMOs”) as market conditions made securities issued by federal agencies less attractive. Market conditions also increased the value of our collateralized loan obligations (“CLOs”), which led many holdings to be called during 2017. Some reinvestment into newer issue CLOs occurred, but the overall CLO portfolio size was reduced significantly. The securities portfolio composition did not change materially in 2018 compared to 2017, and higher yields on our securities resulted in a \$1.8 million increase to interest income for 2018 compared to 2017. Net securities gains of \$360,000 and \$474,000 were recorded in 2018 and 2017, respectively, and net securities losses of \$2.2 million were recorded in 2016, related to sales and calls during those years. Average interest bearing liabilities increased to \$1.71 billion in 2018 from \$1.56 billion in 2017, as the need for funding began to rise with the balance sheet growth we experienced.

Management also continued to emphasize credit quality and maintained our capital ratios with continued strong liquidity. In 2018, we experienced loan growth of \$279.4 million, or 17.3%, over 2017. The growth was driven by our ABC Bank acquisition, an active commercial lending team in new and existing markets, the development of a lease lending team, as well as select portfolio purchases of home equity lines of credit totaling \$41.6 million from a third party. Asset quality levels have remained steady over the last few years in comparison to total loans, as nonperforming assets, including PCI loans increased to \$34.5 million for 2018, compared to \$24.0 million for 2017 and \$27.9 million for 2016. The increase in nonperforming assets, including PCI loans, in 2018 was reflective of the approximate 20 credits in PCI status which totaled \$11.0 million as of December 31, 2018. We also continued to take steps to reduce operating expenses and increase net income. Reduced other real estate owned holdings resulted in lower net other real estate owned expenses each year for 2018, 2017 and 2016. As we focused on reducing all noninterest expenses, we were able to maintain our profitable wealth management business and secondary residential real estate originations and sales as important sources of noninterest income.

Critical accounting policies

Our consolidated financial statements are prepared based on the application of accounting policies in accordance with generally accepted accounting principles (“GAAP”) and follow general practices within the banking industry. These policies require the reliance on estimates and assumptions, which may prove inaccurate or are subject to variations. Changes in underlying factors, assumptions, or estimates could have a material impact on our future financial condition and results of operations. The most critical of these significant accounting policies are the policies related to the allowance for loan and lease losses, and fair valuation methodologies. In addition, as a result of our acquisition of GCFC and its wholly-owned subsidiary, ABC Bank, that closed on April 20, 2018, we implemented accounting policies regarding loans purchased in a business combination. These estimates, assumptions, and judgments are based on information available as of the date of the consolidated financial statements. Future changes in information may affect these estimates, assumptions, and judgments, which, in turn, may affect amounts reported in the consolidated financial statements.

Significant accounting policies are presented in Note 1 of the financial statements included in this annual report. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Recent accounting pronouncements and standards that have impacted or could potentially affect the Company are also discussed in Note 1 of the consolidated financial statements.

Allowance for loan and lease losses

The allowance for loan and lease losses (“ALLL”) represents management’s estimate of probable credit losses inherent in the loan and lease portfolio. Determination of the ALLL is inherently subjective since it requires significant estimates and management judgment, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on a migration analysis that uses historical loss experience, consideration of current economic trends, portfolio growth and concentration risk, management and staffing changes, and other credit market factors.

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The ALLL methodology consists of (i) specific reserves established for probable losses on individual loans or leases for which the recorded investment in the loan or lease exceeds the present value of expected future cash flows or the net realizable value of the underlying collateral, if collateral dependent, (ii) an allowance based on an analysis that uses historical credit loss experience for each loan or lease category, and (iii) the impact of other internal and external qualitative and credit market factors as assessed by management through detailed review of loans, allowance analysis and credit discussions.

The ALLL is a valuation allowance for losses, increased by the provision for loan and lease losses and decreased by both loan loss reserve releases and charge-offs less recoveries. Management estimates the allowance balance required using an assessment of various risk factors including, but not limited to, past loan loss experience, known and inherent risks in the portfolio, information about specific borrower situations, estimated collateral values, volume trends in delinquencies, nonaccruals, economic conditions, and other credit market considerations. Allocations of the allowance may be made for specific loans or leases, but the entire allowance is available for losses inherent in the loan and lease portfolio.

Management incorporated methodology changes in the ALLL calculation in both 2017 and 2018 to further refine the process. These methodology changes are described in the “Allowance for Loan and Lease Losses” section of this “Management Discussion and Analysis of Financial Condition and Results of Operations.” As a result of management’s analysis of the adequacy of the ALLL, a loan and lease loss provision was recorded in 2018, 2017 and 2016.

A loan is considered impaired when it is probable that not all contractual principal or interest due will be received according to the original terms of the loan agreement. Management defines the measured value of an impaired loan based upon the present value of the future cash flows, discounted at the loan’s original effective interest rate, or the fair value reflecting costs to sell the underlying collateral, if the loan is collateral dependent. Impaired loans were \$20.4 million at December 31, 2018, compared to \$20.1 million at December 31, 2017 and \$22.3 million at December 31, 2016. In addition, a discussion of the factors driving changes in the amount of the ALLL is included in the “Allowances for Loan and Lease Losses” section that follows.

Income Taxes

We recognize expense for federal and state income taxes currently payable as well as deferred federal and state taxes, estimated future tax effects of temporary differences between the tax basis of assets and liabilities and amounts reported in the consolidated balance sheets, as well as loss carryforwards and tax credit carryforwards. Net deferred tax assets totaled \$21.3 million as of December 31, 2018, compared to \$25.4 million as of December 31, 2017. Federal deferred tax assets related to net operating losses totaled \$7.6 million as of December 31, 2018, compared to \$34.5 million as of December 31, 2017. We had \$39.9 million of state net operating losses as of December 31, 2018, compared to \$74.1 million of state net operating losses as of December 31, 2017. We recorded a deferred tax asset of \$3.5 million in 2018 related to the ABC Bank acquisition, which totaled \$2.5 million as of December 31, 2018, and increased net operating losses by approximately \$1.0 million related to ABC Bank security

sales at acquisition. We maintain deferred tax assets for deductible temporary differences, the largest of which related to the goodwill amortization/impairment recorded in 2009. For income tax return purposes this relates to Section 197 goodwill amortization and goodwill impairment charges. Realization of deferred tax assets is dependent upon generating sufficient taxable income in either the carryforward or carryback periods to cover net operating losses generated by the reversal of temporary differences. Any change in tax rate will be recorded in the period enacted, which was evidenced by the \$1.6 million income tax credit recorded in the third quarter of 2017 due to the State of Illinois tax rate change in July 2017, as well as the \$9.5 million income tax expense recorded in the fourth quarter of 2017 for the enactment of the "Tax Cuts and Jobs Act."

Future issuances or sales of common stock or other equity securities could also result in an "ownership change" as defined for U.S. federal income tax purposes. If an ownership change were to occur, we could realize a loss of a portion of our U.S. federal and state deferred tax assets, including certain built-in losses that have not been recognized for tax purposes, as a result of the operation of Section 382 of the Internal Revenue Code of 1986, as amended. The amount of the permanent loss would be determined by the annual limitation period and the carryforward period (generally up to 20 years for federal net operating losses) and any resulting loss could have a material adverse effect on the results of operations and financial condition.

On September 12, 2012, the Company and the Bank, as rights agent, entered into a Rights Plan which was designed to protect our deferred tax assets against an unsolicited ownership change. The Rights Plan, as amended, expired in September 2018, and we determined not to seek to extend the plan as we believe the current risk of losing use of the deferred tax asset is remote due to the trend of net income generation over the past few years, and the diminishing balance of the remaining deferred tax asset.

Income tax returns are also subject to audit by the Internal Revenue Service (the "IRS") and state taxing authorities. Income tax expense for current and prior periods is subject to adjustment based on the outcome of such audits. We are currently open to audit under the statute of limitations by the Internal Revenue Service from 2015 to 2017, the state of Illinois from 2015 to 2017, and the states of Wisconsin and Indiana from 2009 to 2017. We believe we have adequately accrued for all probable income taxes payable.

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Fair Value

The use of fair values is required in determining the carrying values of certain assets and liabilities, as well as for specific disclosures. Fair value is an estimate of the exchange price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction (i.e., not a forced transaction, such as a liquidation or distressed sale) between market participants at the measurement date and is based on the assumptions market participants would use when pricing an asset or liability.

In determining the fair value of financial instruments, market prices of the same or similar instruments are used whenever such prices are available. If observable market prices are unavailable or impracticable to obtain, we are required to make judgments about assumptions market participants would use in estimating the fair value of the financial instrument. Fair value is estimated using modeling techniques and incorporates assumptions about interest rates, duration, prepayment speeds, risks inherent in a particular valuation technique and the risk of nonperformance. These assumptions are inherently subjective as they require material estimates, all of which may be susceptible to significant change. In 2018, we adopted ASU 2016-01, which, among other topics addressed, required business entities to use the exit price notion, as defined in ASC 820, for the measurement of the fair value of financial instruments. Adoption of this standard resulted in our use of an exit price rather than an entrance price to determine the fair value of loans and deposits not already measured at fair value on a non-recurring basis in the consolidated balance sheet disclosures; see Note 19 “Fair Value of Financial Instruments” for further information regarding the valuation processes.

Note 18, “Fair Value Measurements,” to the consolidated financial statements includes information about the extent to which fair value is used to measure assets and liabilities and the valuation methodologies and key inputs used.

Loans Acquired in Business Combinations

We record purchased loans at fair value at the date of acquisition based on a discounted cash flow methodology that considers various factors, including the type of loan and related collateral, classification status, whether the loan has a fixed or variable interest rate, its term and whether or not the loan was amortizing, and our assessment of risk inherent in the cash flow estimates. These cash flow evaluations are inherently subjective as they require material estimates, all of which may be susceptible to significant change. Purchased loans are segregated into two categories upon purchase: (1) loans purchased without evidence of deteriorated credit quality since origination, referred to as purchased non-credit impaired (“non-PCI”) loans, and (2) loans purchased with evidence of deteriorated credit quality since origination for which it is probable that all contractually required payments will not be collected, referred to as purchased credit impaired (“PCI”) loans.

We account for and evaluate PCI loans for impairment in accordance with the provisions of ASC 310-30. We estimate the cash flows expected to be collected on purchased loans based upon the expected remaining life of the loans, which includes the effects of estimated prepayments. Cash flow evaluations are inherently subjective as they require material estimates, all of which may be susceptible to significant change. We will perform re-estimations of cash flows on our PCI loan portfolio on a quarterly basis. Any decline in expected cash flows as a result of these re-estimations, due in any part to a change in credit, is deemed credit impairment, and recorded as provision for loan and lease losses during the period. Any decline in expected cash flows due only to changes in expected timing of cash flows is recognized prospectively as a decrease in yield on the loan and any improvement in expected cash flows, once any previously recorded impairment is recaptured, is recognized prospectively as an adjustment to the yield on the loan.

Non-PCI loans outside the scope of ASC 310-30 are accounted for under ASC 310-20. For non-PCI loans, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value and the discount is accreted to interest income over the life of the loan. Subsequent to the purchase date, the method used to evaluate the sufficiency of the credit discount is similar to organic loans, and if necessary, additional reserves are recognized in the allowance for loan and lease losses.

Non-GAAP Financial Measures

This annual report contains references to financial measures that are not defined in GAAP. Such non-GAAP financial measures include the presentation of net interest income and net interest income to interest earning assets on a tax equivalent (“TE”) basis and our tangible common equity to tangible assets ratio. Management believes that the presentation of these non-GAAP financial measures (a) provides important supplemental information that contributes to a proper understanding of our operating performance, (b) enables a more complete understanding of factor and trends affecting our business, and (c) allows investors to evaluate our performance in a manner similar to management, the financial services industry, bank stock analysts, and bank regulators. Management uses non-GAAP measures as follows: in the preparation of our operating budgets, monthly financial performance reporting, and in our presentation to investors of our performance. However, we acknowledge that these non-GAAP financial measures have a number of limitations. Limitations associated with non-GAAP financial measures include the risk that persons might disagree as to the appropriateness of items comprising these measures and that different companies might calculate these measures differently. These disclosures should not be considered an alternative to our GAAP results. A reconciliation of non-GAAP financial measures to the most directly comparable GAAP financial measures is presented below or alongside the first instance where each non-GAAP financial measure is used.

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Results of operations

Net interest income

Net interest income, which is our primary source of earnings, is the difference between interest income earned on interest-earning assets, such as loans and investment securities, as well as accretion income on purchased loans, and interest incurred on interest-bearing liabilities, such as deposits and borrowings. Net interest income depends upon the relative mix of interest-earning assets and interest-bearing liabilities, the ratio of interest-earning assets to total assets and of interest-bearing liabilities to total funding sources, and movements in market interest rates. Our net interest income can be significantly influenced by a variety of factors, including overall loan demand, economic conditions, credit risk, the amount of nonearning assets including nonperforming loans and PCI loans, the amounts of and rates at which assets and liabilities reprice, variances in prepayment of loans and securities, early withdrawal of deposits, exercise of call options on borrowings or securities, a general rise or decline in interest rates, changes in the slope of the yield-curve, and balance sheet growth or contraction. Our asset and liability committee (“ALCO”) seeks to manage interest rate risk under a variety of rate environments by structuring our balance sheet and off-balance sheet positions. This process is discussed in more detail in the section entitled “Interest rate risk” in “Quantitative and Qualitative Disclosures about Market Rate Risk.”

Our net interest income increased \$16.1 million, or 21.4%, from \$74.9 million for the year ended December 31, 2017, to \$90.9 million for the year ended December 31, 2018. The increase in interest and dividend income in 2018 was primarily driven by our acquisition of ABC Bank, and was partially offset by increases in interest expense. Our net interest margin on a taxable equivalent basis, which is net interest income divided by total interest-earning assets, was 3.96% for the year ended 2018, compared to 3.70% for the year ended 2017, an increase of 26 basis points. The growth in our net interest margin was due to higher loan volumes in 2018, coupled with \$2.7 million of discount accretion on loans acquired in our ABC Bank acquisition in 2018 and Talmer branch purchase in late 2016, and higher yielding municipal securities held for the full year 2018. The increase in interest expense in 2018 compared to 2017 was due primarily to higher rates paid on time deposits, as well as additional short-term funding needs, which increased due to our loan growth and was financed by FHLBC borrowings, which reprice daily.

Our net interest income increased \$11.4 million, or 18.0%, from the year ended December 31, 2016, to \$74.9 million for the year ended December 31, 2017. The increase in interest and dividend income in 2017 was partially offset by increases in interest expense. Our net interest margin on a taxable equivalent basis, which is net interest income divided by total interest-earning assets, was 3.70% for the year ended 2017, compared to 3.31% for the year ended 2016, an increase of 39 basis points. The growth in our net interest margin was due primarily to higher loan volumes in 2017, coupled with \$1.3 million of discount accretion on loans acquired in our Talmer branch purchase in late 2016. The increase in interest expense in 2017 compared to 2016 was due primarily to higher rates paid on time deposits, as well as a full year of interest expense on senior notes issued in December 2016, which were issued at a higher rate than the subordinated notes we simultaneously retired in December 2016.

Our average earning assets increased \$238.2 million, or 11.3%, to \$2.35 billion in 2018, from \$2.11 billion in 2017. The increase was primarily attributable to our ABC Bank acquisition, organic commercial, lease financing, commercial real estate, and construction loan growth and our purchase of two HELOC portfolios, totaling \$41.6 million from a third party. Our average earning assets increased \$181.3 million, or 9.4%, to \$2.11 billion in 2017, from \$1.93 billion in 2016. The increase was primarily the result of a \$318.8 million increase in average loans and loans held-for-sale, partially offset by a \$116.7 million decrease in average total securities. The increase in average loans in 2017 reflects growth due to our Talmer branch purchase, as well as organic commercial, real estate and lease financing growth.

Our average interest bearing liabilities increased \$153.7 million, or 9.9%, from \$1.56 billion in 2017 to \$1.71 billion in 2018, due primarily to the ABC Bank acquisition in the second quarter of 2018, as well as growth in commercial deposit accounts commensurate with growth in our commercial loan clients, and an increase in short-term borrowings used to fund loan growth. Our average interest bearing liabilities increased \$70.0 million to \$1.56 billion in 2017, from \$1.49 billion in 2016, due primarily to growth in NOW accounts and an increase in other short-term borrowings. In addition, an increase in interest expense was attributable to the change in our debt structure in late 2016, with the retirement of \$45.5 million of subordinated and senior debt due in 2018, and a simultaneous public offering of \$45.0 million of senior notes, which pay at a higher rate. The \$45.0 million in senior notes have a fixed rate at 5.75% for five years, which converts to a floating rate tied to three month LIBOR plus 385 basis points in 2021.

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Analysis of Average Balances,
 Tax Equivalent Interest and Rates
 Years Ended December 31, 2018, 2017 and 2016
 (In thousands)

	2018 Average Balance	Interest	Rate %	2017 Average Balance	Interest	Rate %	2016 Average Balance	Interest	Rate %
Assets									
Interest earning deposits with financial institutions	\$ 17,540	\$ 334	1.90	\$ 12,224	\$ 134	1.08	\$ 33,226	\$ 169	0.50
Securities:									
Taxable	268,791	9,577	3.56	347,712	10,202	2.93	635,914	15,865	2.49
Non-taxable (TE)	277,555	10,558	3.80	208,142	9,137	4.39	36,643	1,295	3.53
Total securities	546,346	20,135	3.69	555,854	19,339	3.48	672,557	17,160	2.55
Dividends from FHLBC and FRBC	9,305	469	5.04	8,127	370	4.55	7,944	333	4.19
Loans and loans held-for-sale									
1	1,778,996	88,922	5.00	1,537,742	70,950	4.55	1,218,931	56,263	4.54
Total interest earning assets	2,352,187	109,860	4.67	2,113,947	90,793	4.25	1,932,658	73,925	3.78
Cash and due from banks	34,021	-	-	33,738	-	-	31,689	-	-
Allowance for loan and lease losses	(18,930)	-	-	(16,390)	-	-	(15,955)	-	-
Other noninterest bearing assets	180,528	-	-	187,503	-	-	194,356	-	-
Total assets	\$ 2,547,806			\$ 2,318,798			\$ 2,142,748		
Liabilities and Stockholders' Equity									
	\$ 436,702	\$ 978	0.22	\$ 425,435	\$ 424	0.10	\$ 389,266	\$ 358	0.09

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NOW									
accounts									
Money									
market									
accounts	307,259	843	0.27	278,826	349	0.13	273,101	274	0.10
Savings									
accounts	291,611	335	0.11	261,974	177	0.07	256,905	157	0.06
Time deposits	443,520	5,829	1.31	389,771	4,227	1.08	404,285	3,640	0.90
Interest									
bearing									
deposits	1,479,092	7,985	0.54	1,356,006	5,177	0.38	1,323,557	4,429	0.33
Securities									
sold under									
repurchase									
agreements	44,122	462	1.05	31,478	17	0.05	34,016	4	0.01
Other									
short-term									
borrowings	71,041	1,429	2.01	67,959	741	1.08	26,518	102	0.38
Junior									
subordinated									
debentures	57,663	3,716	6.44	57,615	4,002	6.95	57,567	4,334	7.53
Senior notes	44,109	2,688	6.09	44,010	2,689	6.11	2,050	112	5.46
Subordinated									
debt	-	-	-	-	-	-	42,910	949	2.18
Notes payable									
and other									
borrowings	14,696	398	2.71	-	-	-	477	8	1.65
Total interest									
bearing									
liabilities	1,710,723	16,678	0.97	1,557,068	12,626	0.81	1,487,095	9,938	0.67
Noninterest									
bearing									
deposits	608,762	-	-	547,719	-	-	476,422	-	-
Other									
liabilities	16,742	-	-	22,131	-	-	12,929	-	-
Stockholders'									
equity	211,579	-	-	191,880	-	-	166,302	-	-
Total									
liabilities and									
stockholders'									
equity	\$ 2,547,806			\$ 2,318,798			\$ 2,142,748		
Net interest									
income (TE)		\$ 93,182			\$ 78,167			\$ 63,987	
Net interest									
margin (TE)			3.96			3.70			3.31
Interest									
bearing									
liabilities to									
earning assets	72.73	%		73.66	%		76.95	%	

1 Interest income from loans is shown tax equivalent basis, which is a non-GAAP financial measure, as discussed in Guide 3 "Statistical Data Requirements", Item I, and includes fees of \$1.1 million, \$2.4 million and \$2.5 million for 2018, 2017 and 2016, respectively. Nonaccrual loans are included in the above stated average balances.

Provision for loan and lease losses

We recorded a provision for loan and lease losses in 2018 of \$1.2 million, compared to \$1.8 million in 2017 and \$750,000 in 2016. For additional discussion of the loan and lease loss provision and allowance, see the section below "Allowance for Loan and Lease Losses" in Item 7. Management's Discussion and Analysis of Financial Condition.

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Noninterest income

(in thousands)	Noninterest Income for the Twelve			Percent Change From	
	2018	2017	2016	2018-2017	2017-2016
Trust income	\$ 6,417	\$ 6,203	\$ 5,670	3.4	9.4
Service charges on deposits	7,328	6,720	6,684	9.0	0.5
Residential mortgage banking revenue					
Secondary mortgage fees	696	776	1,038	(10.3)	(25.2)
Mortgage servicing rights mark to market loss	(734)	(802)	(919)	8.5	12.7
Mortgage servicing income	1,939	1,778	1,724	9.1	3.1
Net gain on sales of mortgage loans	3,791	4,803	6,343	(21.1)	(24.3)
Total residential mortgage banking revenue	5,692	6,555	8,186	(13.2)	(19.9)
Securities gains (losses), net	360	474	(2,213)	(24.1)	121.4
Increase in cash surrender value of BOLI	984	1,432	1,283	(31.3)	11.6
Death benefit realized on bank-owned life insurance	1,026	-	-	100.0	-
Debit card interchange income	4,420	4,200	4,027	5.2	4.3
Gains (losses) on disposal and transfer of fixed assets	-	10	(1)	(100.0)	N/M
Other income	5,126	4,778	4,938	7.3	(3.2)
Total noninterest income	\$ 31,353	\$ 30,372	\$ 28,574	3.2	6.3

N/M - Not meaningful

Our total noninterest income increased \$981,000 to \$31.4 million in 2018, compared to \$30.4 million in 2017. We continued to implement our strategy to grow trust income and service charges on deposits, subject to applicable bank regulations. Trust income increased \$214,000 in 2018 from 2017, due primarily to growth in agent fees, IRA management fees, and management emphasis on advisory fee growth. Average assets under management by our wealth management department totaled \$1.18 billion for 2018, reflecting growth of \$72.4 million, or 6.5%, from the 2017 average assets under management of \$1.11 billion. Service charges on deposits increased \$608,000 in 2018 from 2017 due primarily to growth in commercial demand related account fees, as a result of increases in commercial demand deposit balances commensurate with management's focus on growing commercial loans. Residential mortgage banking revenue declined \$863,000 in 2018 from 2017, due primarily to a rising interest rate environment and the negative impact of the rate changes to mortgage servicing rights, as well as a reduction of \$12.9 million in mortgage loans originated for sale in 2018. Security gains, net, of \$360,000 were recorded in 2018, relating to security sales of \$94.7 million, compared to security gains, net, of \$474,000 in 2017 related primarily to \$232.5 million of securities sales in 2017. We recorded a death benefit of \$1.0 million on bank owned life insurance, or BOLI, in 2018, which was partially offset by a reduction in the increase in cash surrender value of BOLI compared to 2017. An increase was reflected in debit card interchange income due to a reversal of \$250,000 related to an accrual for a debit card rewards program that was discontinued in late 2018. Finally, other income increased \$348,000 in 2018 compared to 2017 due to an increase in ATM transaction fees and miscellaneous recoveries, primarily related to a reversal of property tax accruals taken in prior years on nonperforming loans.

Our total noninterest income increased \$1.8 million, to \$30.4 million in 2017, compared to \$28.6 million in 2016. Trust income increased \$533,000 in 2017 from 2016, due primarily to growth in estate fees and management emphasis on advisory fee growth. Service charges on deposits increased \$36,000 in 2017 from 2016 due primarily to growth in commercial demand related account fees, as a result of increases in commercial demand deposit balances commensurate with management's focus on growing commercial loans. Residential mortgage banking revenue declined \$1.6 million in 2017 from 2016, due primarily to a rising interest rate environment. Mortgage originations decreased \$47.0 million in 2017 from 2016, and proceeds from mortgage sales declined \$45.4 million in 2017 compared to 2016. However, mortgage servicing rights mark to market loss showed a slight improvement of \$117,000 for 2017, compared to 2016. Securities gains were \$474,000 for 2017, compared to net losses on securities of \$2.2 million in 2016, primarily due to security sales in 2016 stemming from funding needs related to the Talmer branch acquisition. The cash surrender value of BOLI increased \$149,000 in 2017, compared to 2016, due to the rising interest rate environment.

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Noninterest expense

(in thousands)	Noninterest Expense for the Twelve			Percent Change From	
	Months ending December 31,			2018-2017	2017-2016
	2018	2017	2016		
Salaries	\$ 34,031	\$ 31,096	\$ 28,823	9.4	7.9
Officers incentive	3,131	2,637	1,988	18.7	32.6
Benefits and other	6,999	6,347	5,423	10.3	17.0
Total salaries and employee benefits	44,161	40,080	36,234	10.2	10.6
Occupancy, furniture and equipment	6,915	5,951	6,063	16.2	(1.8)
Computer and data processing	6,745	4,387	4,349	53.7	0.9
FDIC insurance	653	658	865	(0.8)	(23.9)
General bank insurance	1,040	1,031	1,109	0.9	(7.0)
Amortization of core deposit intangible	387	96	16	N/M	N/M
Advertising expense	1,567	1,505	1,633	4.1	(7.8)
Debit card interchange expense	940	1,329	1,455	(29.3)	(8.7)
Legal fees	835	650	800	28.5	(18.8)
Other real estate owned expense, net	396	2,165	2,743	(81.7)	(21.1)
Other expense	13,489	11,297	11,494	19.4	(1.7)
Total noninterest expense	\$ 77,128	\$ 69,149	\$ 66,761	11.5	3.6

N/M - Not meaningful

Our total noninterest expense increased by \$8.0 million, or 11.5%, in 2018 compared to 2017. The increase was primarily attributable to our acquisition of ABC Bank in the second quarter of 2018, which resulted in aggregate merger and acquisition related costs of \$3.5 million in 2018. In addition, growth in our employees and branches from the ABC Bank acquisition has contributed to increased salaries and employee benefits and occupancy, furniture and equipment expense in 2018. Total salaries and employee benefits increased 10.2% in 2018 compared to 2017, occupancy, furniture and equipment costs increased 16.2% in 2018 compared to 2017, and computer and data processing costs increased 53.7%, due primarily to the data conversion and contract exit costs related to the acquisition. Our other real estate owned expenses, net, decreased \$1.8 million in 2018 compared to 2017, as a result of decreases in maintenance costs due to the reduction in our other real estate owned balances, a decrease in valuation reserves taken in 2018, and an increase in gains on sales of properties held in 2018. Other expense reflected an increase of \$2.2 million in 2018 over 2017 primarily due to ABC Bank acquisition related costs of \$582,000, an increase in consulting costs of \$300,000 related to third party stress testing, various operational reviews, and preparation for the implementation of CECL, and a loss incurred related to a mortgage escrow reimbursement payable to a loan customer of \$240,000.

Our total noninterest expense increased by \$2.4 million, or 3.6%, in 2017 compared to 2016. Total salaries and employee benefits increased 10.6% in 2017 compared to 2016, primarily as a result of growth in salaries, insurance and other benefits costs, and increased officer incentives due to improved corporate performance. Other real estate

owned expenses, net, decreased \$578,000 in 2017 compared to 2016, reflecting the declining balances held in other real estate owned.

Our number of full-time equivalent employees increased by 68 in 2018, stemming primarily from our ABC Bank acquisition. Management continues to be diligent in controlling the hiring of additional personnel, even as positions become open, as we seek to efficiently utilize our current staff and control expenses.

Income taxes

Our provision for income taxes includes both federal and state income tax expense (benefit). An analysis of the provision for income taxes for the three years ended December 31, 2018, is detailed in Note 12 of the consolidated financial statements and our income tax accounting policies are described in Note 1 to the consolidated financial statements.

Our income tax expense totaled \$9.9 million for the year ended December 31, 2018, compared to an income tax expense of \$19.2 million in 2017, and \$8.8 million in 2016. Income tax expense reflected all relevant statutory tax rates and GAAP accounting. Our effective tax rate was 22.6%, 55.9%, and 36.0% in 2018, 2017, and 2016, respectively. Any changes in tax rates will be recorded in the period enacted.

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law, which resulted in a reduction in the Federal income tax rate from 35% to 21%, thereby decreasing our deferred tax asset by \$9.5 million and increasing our income tax expense. In addition, in

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July 2017, the State of Illinois enacted a tax rate change which resulted in us recording a \$1.6 million increase to the deferred tax asset and an income tax credit.

On September 2, 2015, the Company and the Bank, as rights agent (the “Rights Agent”), entered into a Second Amendment to Amended and Restated Rights Agreement and Tax Benefits Preservation Plan (the “Amendment”), which amended the Amended and Restated Rights Agreement and Tax Benefits Preservation Plan, dated as of September 12, 2012, between the Company and the Rights Agent (as amended, the “Tax Benefits Plan”). This amendment was submitted and approved by our stockholders at the Company’s 2016 annual meeting, which extended the final expiration date of the Tax Benefits Plan from September 12, 2015 to September 12, 2018. The Tax Benefits Plan expired on September 12, 2018, and our board of directors determined not to extend it.

The determination of whether we will be able to realize our deferred tax assets is highly subjective and dependent upon judgment concerning management’s evaluation of both positive and negative evidence, including forecasts of future income, available tax planning strategies, and assessments of the current and future economic and business conditions. Management considered both positive and negative evidence regarding our ability to ultimately realize the deferred tax assets, which is largely dependent upon the ability to derive benefits based upon future taxable income. For all periods presented, management determined that the realization of the deferred tax asset was “more likely than not” as required by GAAP.

There have been no significant changes in our ability to utilize the deferred tax assets through December 31, 2018. We had no valuation reserve on the deferred tax assets as of December 31, 2018.

Financial condition

General

Our total assets were \$2.68 billion at December 31, 2018, an increase of \$292.6 million, or 12.3%, from December 31, 2017. Our loans increased by 17.3%, to \$1.90 billion for the year ended December 31, 2018, compared to 2017. While the majority of the increase is due to \$227.6 million of loans recorded, net of purchase accounting adjustments, from our acquisition of ABC Bank in April 2018, we also experienced organic loan and lease growth in 2018, and also made purchases of HELOCs totaling \$41.6 million in 2018. Total securities marginally decreased by \$191,000, or 0.04%, for the year ended December 31, 2018, as our portfolio mix remained static overall. In 2018, management continued to emphasize the stabilization of our balance sheet and credit quality in all lending decisions. We also continued to experience a high level of competition for loans in our target markets. The balance of our other real estate owned remained relatively stable at \$7.4 million as of December 31, 2018, compared to \$8.4 million as of December 31, 2017.

Our total liabilities were \$2.45 billion at December 31, 2018, an increase of \$263.8 million, or 12.1%, from December 31, 2017. Total deposits increased by \$193.7 million, or 10.1%, to \$2.12 billion for the year ended December 31, 2018, compared to \$1.92 billion for the year ended December 31, 2017, due to the acquisition of ABC Bank deposits which totaled \$248.5 million, less modest deposit attrition after acquisition. Management continued to fund new lending with deposit growth, short term borrowings from the Federal Home Loan Bank of Chicago (the “FHLBC”), securities sold under repurchase agreements, long-term FHLBC borrowings acquired with the ABC Bank acquisition which are recorded within notes payable and other borrowings, and modest levels of security sales.

At December 31, 2018, total stockholders’ equity was \$229.1 million, compared to \$200.4 million at December 31, 2017.

Investments

As shown below, we experienced minimal changes in the composition of our securities portfolio from 2017 to 2018, compared to more significant changes from 2016 to 2017 due to net security sales during 2017.

(in thousands)	Securities Portfolio as of December 31,			Percent Change From	
	2018	2017	2016	2018-2017	2017-2016
Securities available-for-sale, at fair value					
U.S. Treasury	\$ 3,923	\$ 3,947	\$ -	(0.6)	N/M
U.S. government agencies	10,951	13,061	-	(16.2)	N/M
U.S. government agency mortgage-backed States and political subdivisions	14,075	12,214	41,534	15.2	(70.6)
Corporate bonds	274,067	278,092	68,703	(1.4)	304.8
Collateralized mortgage obligations	-	833	10,630	(100.0)	(92.2)
Asset-backed securities	64,429	65,939	170,927	(2.3)	(61.4)
Collateralized loan obligations	109,514	112,932	138,407	(3.0)	(18.4)
Total securities available-for-sale	64,289	54,421	101,637	18.1	(46.5)
	\$ 541,248	\$ 541,439	\$ 531,838	(0.0)	1.8

N/M - Not meaningful

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Our investment portfolio serves as both an important source of liquidity and as a source of income for the Company. Accordingly, the size and composition of the portfolio reflects our liquidity needs, loan demand and interest income objectives.